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IN THE

Supreme Court of the United States

October Term, 1971

Docket No. .....

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, CLAUDE O. STEPHENS, EARL L. HUNTINGTON and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

APPENDICES

INDEX TO APPENDICES

PAGE

Appendix A

Opinion of the District Court (Dated August 16, 1966) 1a

Judgment of the District Court (Entered August 22, 1966) 64a

Opinion of the Court of Appeals (Decided August 13, 1968) 66a

Judgment of the Court of Appeals (Entered August 13, 1968) 172a

Second Opinion of the District Court (Dated February 6, 1970) 175a

Second Judgment of the District Court (Entered April 16, 1970) 215a

Second Opinion of the Court of Appeals (Decided June 10, 1971) 220a

Second Judgment of the Court of Appeals (Entered June 10, 1971) 234a

Appendix B

Constitutional Provisions, Statutes and Rules Involved 235a

APPENDIX A

Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 Civ. 1182

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

against

TEXAS GULF SULPHUR COMPANY, a Texas corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M CRAWFORD, THOMAS S. LAMONT, FRANCIS G. COATES, CLAUDE O. STEPHENS, THOMAS P. O'NEILL, JOHN A. MURRAY, EARL L. HUNTINGTON and HAROLD B. KLINE,

Defendants.

(5436) BONSAL, D. J.

Plaintiff, Securities and Exchange Commission (Commission), has instituted this action charging each of the defendants with violations of Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5 (17 C.F.R. 240; 10b-5) promulgated thereunder by the Commission. All parties waived a jury and agreed that trial should first be had on the issue of whether the defendants or any of them had violated Section 10(b) and Rule 10b-5, reserving for later hearing the issue of the remedy to be applied in the event such violations are found.

The Commission's action arises out of the exploratory activities of defendant Texas Gulf Sulphur Company (TGS) on the Kidd 55 segment near Timmins, Ontario, between November 12, 1963 and April 16, 1964. TGS is (5437) alleged to have violated Section 10(b) and Rule 10b-5 by issuing a false press release regarding these activities on April 12, 1964. Each of the individual defendants was a director, officer or employee of TGS. Individual defendants who purchased stock or calls on stock of TGS between November 12, 1963 and April 16, 1964, or recommended such purchases to others, are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they used to their own advantage material information as to TGS's exploratory activities on the Kidd 55 segment, which material information had not been disclosed to or absorbed by the stockholders or the public. Five of the individual defendants who accepted stock options granted on February 20, 1964 are charged with violations of Section 10(b) and Rule 10b-5 on the ground that they

were in possession of such material information which they used to their own advantage by failing to disclose it to the Directors' Committee which granted the stock options.[1]

TEXAS GULF SULPHUR COMPANY (TGS)

In 1963 64 TGS (which was organized in 1909) was the world's largest supplier of sulphur. Its authorized capital stock was 15,000,000 shares, without par value. (5438) 11,520,000 shares had been issued (including 1,504,101 shares held in the Company's treasury). On December 31, 1963, there were issued and outstanding in the hands of the public in excess of 10,000,000 shares held by some 65,000 shareholders. The stock of TGS was listed on the New York Stock Exchange and was admitted to unlisted trading privileges on the Midwest Stock Exchange. TGS's total assets, less current liabilities, had a book value of over $169,000,000 as of December 31, 1963, and over $210,000,000 as of December 31, 1964. The stockholders' equity was stated to be in excess of $129,000,000 as of December 31, 1963, and in excess of $137,000,000 as of December 31, 1964. Its annual sales were in excess of $62,000,000 for 1963 and in excess of $70,000,000 for 1964. Its working capital was approximately $47,000,000 as of December 31, 1963, and approximately $87,000,000 as of December 31, 1964. Its earnings per share for the period 1960-1964 were:

1960	1961	1962	1963	1964
$1.27	$1.26	$1.21	$0.93	$1.15

From 1955 to 1963 TGS's annual sales declined from $93,000,000 in 1955 to $62,000,000 in 1963 and its (5439) annual earnings from $32,000,000 in 1955 to $9,300,000 in 1963. This decline was attributed by TGS to the oversupply of sulphur, resulting in depressed prices during the period.

The market price of TGS stock on the New York Stock Exchange declined from a high of $45 a share in 1955 to a low of $11 a share in 1962. In 1963 the price rose from 13¾ in March to 19⅜ in November and to 21⅞ at the end of the year. In 1964 the price rose from a low of 21⅛ in January to a high of 30¼ on April 15. On April 16, the day of TGS's public announcement of the Kidd mine, the price rose from a low of 30⅛ to a high of 37, closing at 36⅜. The price continued to rise during the balance of April 1964 to a high of 58⅜ on April 30, on which day the stock closed at 54¾.

Between 1956 and 1963, despite a growth in the demand for sulphur, the price per ton of sulphur declined from around $28 in 1956 to under $20 in 1963. However, by late 1963 the turn-around had been reached. Sulphur became in short supply, and on April 1, 1964 TGS announced a $2 per ton increase in the price. TGS's gross sales for (5440) 1963 were the highest in four years, up 5.56% from 1962.

TGS's 1963 earnings were adversely affected by the mysterious loss of the S.S. MARINE SULPHUR QUEEN early in that year. In January 1964 TGS put into service a larger liquid sulphur cargo vessel to replace the lost vessel and announced the launching of the world's largest liquid sulphur tanker, which would make it possible to ship liquid sulphur to Europe, and on February 8, 1964 it announced plans to increase its Canadian production of sulphur by 500 tons per day.

Apart from its primary sulphur business, TGS was engaged in a diversification program in other fields, such as phosphate, potash, trona, oil and gas. Its entry into the phosphate and potash fields was important because phosphate, potash and sulphur are the three basic components of fertilizers. On November 15, 1963, TGS announced the creation of a new division for its phosphate project and that its potash mine was near completion and was scheduled

to go into production in the spring of 1964. On December 16, 1963, TGS announced that it had acquired the Canadian oil and gas properties of Delhi-Taylor Oil Company, and on April 3, 1964 announced plans (5441) to proceed with a 3,000,000 ton-per-year phosphate program in North Carolina at a cost of $45,000,000.

TGS had been engaged in exploration for sulphide deposits on the Canadian Shield since 1957 and in 1963-64 undertook exploratory work on the Kidd 55 segment in Kidd Township near Timmins, Ontario, which is more fully described hereafter.

The Individual Defendants

The individual defendants are directors, officers and employees of TGS as follows:

Defendant	Position
Claude O. Stephens	President and Director
Charles F. Fogarty	Executive Vice President* and Director
Thomas S. Lamont	Director
Francis G. Coates	Director
Harold B. Kline	Vice President and General Counsel**
Richard D. Mollison	Vice President
David M. Crawford	Secretary***
Richard H. Clayton	Engineer
Walter Holyk	Chief Geologist
Kenneth H. Darke	Geologist
Earl L. Huntington	Attorney
John A. Murray	Office Manager

* Prior to February 20, 1964 Mr. Fogarty was Senior Vice President.

** Prior to January 31, 1964 Mr. Kline was Vice President-Administration and Secretary.

*** Mr. Crawford was employed by TGS in January 1964 and became Secretary on February 20, 1964.

(5442) Defendant Thomas P. O'Neill was an accountant with TGS. He was served with a summons and complaint, but has failed to answer or appear. The Commission has moved for a default judgment against O'Neill in a separate proceeding. Therefore he is not referred to hereafter.

Summary of TGS's Exploratory Activities on the Kidd 55 Segment

Exploration on the Canadian Shield:

In 1957 TGS initiated an exploration program for sulphides[2] on the Canadian Shield, a vast area comprising most of eastern Canada. Much of the area is barren and flat with few outcroppings of rock and is covered with a swampy material known as muskeg. The subsurface structure consists of Pre-Cambrian rocks, dating from an early geologic time, and is complex and distorted.

(5443) Beginning in March, 1959, an exploration group—headed by defendant Mollison, a mining engineer, and consisting of defendant Holyk, the chief geologist; defendant Clayton, an electrical engineer and geophysicist; and defendant Darke, a geologist—conducted aerial geophysical surveys over more than 15,000 miles of the Canadian Shield area. Sulphides conduct electricity better than most other rock types and can be detected if they are in sufficient quantity and concentration and are not too deeply buried beneath the earth's surface.[3]

In the course of this aerial exploration, TGS detected several thousand anomalies—unusual variations in the conductivity of rocks. In the opinion of the exploration group several hundred of these anomalies were (5444) worthy of further investigation, and rights to land around them were

acquired. One of these anomalies, detected as early as 1959, was located near Timmins, Ontario, and was designated as the Kidd 55 segment. On June 6, 1963, TGS acquired an option to purchase the northeast quarter section (160 acres) of the Kidd 55 segment. Between November 8, 1963 and April 16, 1964 TGS drilled K-55-1, K-55-3, K-55-4, K-55-5, K-55-6, K-55-7 and K-55-10 at the locations shown on the accompanying Plan Map of the Kidd 55 segment.

Drill Hole K-55-1

On October 29 and 30, 1963, defendant Clayton conducted a ground geophysical survey on the northeast quarter section which confirmed the existence of the anomaly previously detected by the aerial survey. Defendant Clayton interpreted the survey as indicating three separate conductors of electricity tending in a north-south direction with an undetermined width and steep dip. Since the survey only indicated the presence of conductive material and not whether the material consisted of worthless or valuable minerals and since there was little geological evidence as to the makeup of the subsurface structure (the (5446) nearest outcroppings of rock were located more than 1,000 feet from the property), diamond core drilling was necessary for

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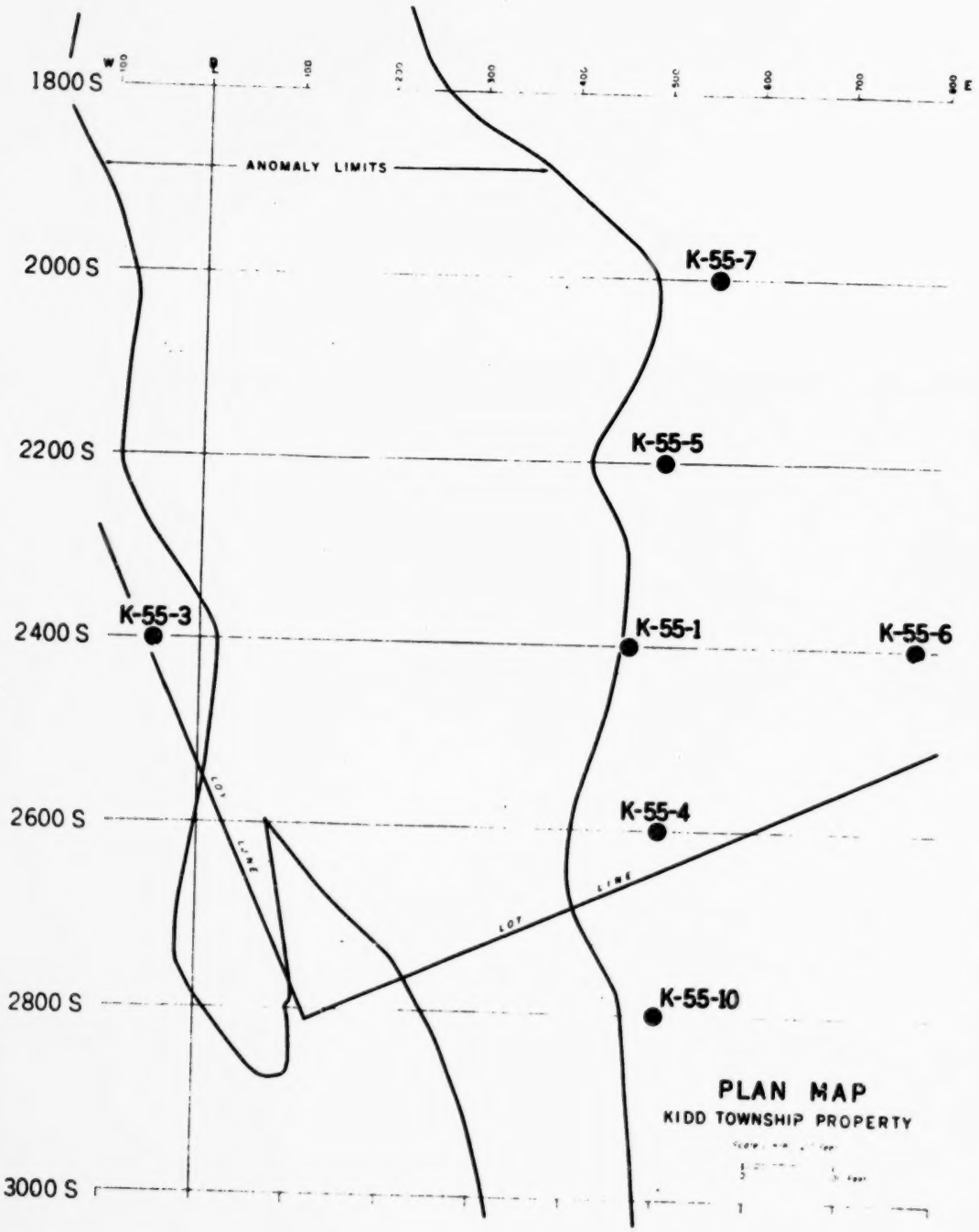
(5445)

Plan Map

KIDD TOWNSHIP PROPERTY

PHOTOPRINT
(Mounted Opposite)


1800 S
2000 S
2200 S
2400 S
2600 S
2800 S
3000 S
ANOMALY LIMITS
K-55-7
K-55-5
K-55-3
K-55-1
K-55-6
K-55-4
K-55-10
LOT LINE
LOT LINE
PLAN MAP
KIDD TOWNSHIP PROPERTY

further evaluation of the anomaly. TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined.

On November 8, 1963, drilling of the initial hole (K-55-1) was begun on section line 2400 S. The location, direction, and angle of the hole were determined by defendants Holyk, Clayton and Darke, who considered the results of the geophysical survey and the location of property boundaries. The collar of the hole was placed about 60 feet to the east of the easternmost conductor, as interpreted by defendant Clayton, and at the strongest part of the anomaly. The hole was drilled westerly at an angle of 60 degrees in the hope that it would cut through all three conductors.

On November 12, 1963, drilling of K-55-1 was terminated at 655 feet. Defendant Holyk visually estimated that the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. The percentages of copper and zinc (5447) mineralization at any given point in the core fluctuated markedly, but the copper mineralization appeared to be concentrated more on the eastern edge of the anomaly.

Property Acquisition

As a result of the visual examination of the core, TGS determined to acquire the three other quarter sections making up the Kidd 55 segment. Therefore, following the usual practice in the mining industry, security measures were put into effect. Further drilling on the anomaly was suspended and members of the exploration group were instructed to keep the results of K-55-1 confidential. The drill rig at the site of K-55-1 was moved away and cut sap-

lings were stuck in the ground in the area of the hole to conceal its location. A second drill hole (K-55-2) was drilled off the anomaly in order to produce a barren core.

The core from K-55-1 was split longitudinally and shipped to the Union Assay House, Salt Lake City, Utah, for chemical assay. In mid-December, TGS received reports from the assay which revealed an average metal content of approximately 1.18% copper and 8.26% zinc, as well as 3.94 ounces of silver per ton over a 602-foot length of the core. These were the only chemical assay reports on any drill hole which TGS received prior to April 16, 1964.

(5448) In the meantime, negotiations for the three other quarter sections comprising the Kidd 55 segment had been undertaken. TGS purchased one quarter-section outright for $7,500 and acquired options for $7,000 to purchase the other two for approximately $45,000. On March 27, TGS decided that the land acquisition program had advanced sufficiently to permit the company to resume drilling.

Drill Hole K-55-3

On March 31, the drilling of K-55-3 was commenced on section line 2400 S approximately 75 feet west of the western limits of the anomaly and approximately 510 feet west of K-55-1. It was drilled easterly at an angle of 45 degrees, and therefore crossed K-55-1 in a vertical plane on section 2400 S. K-55-3 was completed by 7:00 p.m. on April 7 and visual estimates of the core indicated an average copper content of 1.12% and an average zinc content of 7.93% over 641 feet of the hole's 876-foot length. Like K-55-1, K-55-3 indicated substantial copper mineralization on the eastern edge of the anomaly. Daily reports of the progress of K-55-3 and of the subsequent drill holes were made by defendants Mollison and Holyk to defendants Stephens and Fogarty.

(5449) *Drill Hole K-55-4*

On April 7, drilling of K-55-4 was commenced slightly to the east of the eastern edge of the anomaly on section line 2600 S, 200 feet to the south of K-55-1, and was drilled westerly on an angle of 45 degrees, parallel to K-55-1. By 7:00 p.m. on April 9, K-55-4 had encountered mineralization over 366 feet of its 420-foot length, but had entered a stretch of barren material at the 420-foot mark. The hole was completed to a length of 579 feet on April 10 at 7:00 p.m. without encountering further mineralization. Visual estimates of the 366 feet of mineralized core recovered from K-55-4 indicated an average copper content of 1.14% and an average zinc content of 8.24%. Like K-55-1 and K-55-3, K-55-4 encountered substantial copper mineralization on the eastern edge of the anomaly.

Drill Holes K-55-6 and K-55-5

On April 8, drilling of K-55-6 was commenced with a second drill rig[4] on section 2400 S, 300 feet to the east of K-55-1. It was drilled westerly at an angle of 60 degrees and was intended to explore mineralization beneath hole K-55-1. Due to the absence of geologists from the drill site on April 8 and 9,[5] no immediate visual estimates of the core were available. It was apparent, (5450) however, by the evening of April 10 that the hole had encountered substantial copper mineralization over the last 127 feet of its 569-foot length.

On April 10, drilling of K-55-5 was commenced with a third drill rig on section 2200 S, 200 feet north of K-55-1. The hole was started on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees, parallel to the holes previously drilled. By the evening of April 10, K-55-5 had been drilled 97 feet and, although no immediate visual estimates of the core were available, it was apparent

that the hole had intersected substantial copper mineralization over the last 42 feet of its length.

The results of drilling through the evening of April 10 were available to TGS when it issued its April 12 press release.

Core Drilling between 7:00 p.m. April 10 and 7:00 a.m. April 13

Drilling of K-55-5 and K-55-6 continued, and by the morning of April 13, K-55-5 had encountered mineralization to the 580-foot mark. It was subsequently drilled to a length of 757 feet without encountering further mineralization. Visual estimates of the core indicated that over a 525-foot section the drill hole had intersected an average (5451) copper mineralization of 0.82% and an average zinc mineralization of 4.2%. By 7:00 a.m. on April 13, K-55-6 had encountered mineralization to the 946-foot mark. It was subsequently drilled to a length of 1180 feet without intersecting any further mineralization. Visual estimates of a 504-foot section of the core indicated an average copper content of 1.72% and an average zinc content of 6.60%.

On April 12 drilling of K-55-7 was commenced with a fourth drill rig on section 2000 S at the eastern edge of the anomaly. It was drilled westerly at an angle of 45 degrees and by the morning of April 13 had encountered 50 feet of mineralization over the 137 feet drilled. The drilling of a mill test hole, K-55-8, was also commenced by April 11 and completed by the evening of April 13. The core was 2¼ inches in diameter as compared with the 1⅛ inch diameters of the other holes, and was intended to be used for metallurgical testing to determine the amenability to milling of the material that had been encountered. No geologist's log or visual estimates were made of K-55-8 and no metallurgical tests of the core were reported prior to April 16.

(5452) *Core Drilling between 7:00 a.m. April 13 and 7:00 p.m. April 15*

On April 14 drilling of K-55-10 was commenced on section 2800 S on the eastern edge of the anomaly and was drilled westerly at an angle of 45 degrees. By 7:00 p.m. on April 15, it had encountered mineralization over the last 231 feet of the 249 feet of drilling. Drilling of K-55-7 was completed to a length of 707 feet, but encountered only 26 more feet of mineralization between the 425-foot and the 451-foot marks.

Purchase of TGS Stock and Calls on TGS Stock by Certain Defendants and "Tippees" between November 12, 1963 and April 16, 1964

The evidence established that all of the individual defendants except Stephens and Kline purchased shares of TGS and/or calls on TGS stock between November 12,
(5453) 1963, when the first drill hole on the Kidd property was completed (K-55-1), and the close of business on April 16, 1964, the day on which TGS issued a press release announcing the discovery of a copper mine on the Kidd 55 segment at a press conference called for the purpose. The evidence also shows that certain persons who were referred to by counsel at the trial as "tippees" purchased shares of TGS and/or calls on TGS stock on the basis of advice received directly or indirectly from defendants Darke, Coates and Lamont. The following table lists these purchases (including those of defendant Holyk's wife), but does not include the shares covered by stock options granted by TGS to certain defendants on February 20, 1964.

Purchase Date	Purchaser	Shares		Calls	
		Number	Price	Number	Exercise Price
HOLE K-55-1 COMPLETED NOVEMBER 12, 1963					
1963					
Nov 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		
CHEMICAL ASSAYS OF DRILL CORE OF K-55-1 RECEIVED DECEMBER 9-13, 1963					
Dec 10	Holyk (Mrs.)	100	20⅜		
12	Holyk (or wife)			200	21
13	Mollison	100	21⅛		
30	Caskey*			300	22¼
30	Fogarty	200	22		
31	Fogarty	100	23¼		
1964					
Jan 6	Holyk (or wife)			100	23⅝
8	Murray			400	23¼
16	Westreich*	2000	21¼-21¾		
24	Holyk (or wife)			200	22¼-22⅜
Feb 10	Fogarty	300	22⅛-22¼		
17	Atkinson*	50	23¼	200	23⅛
17	Westreich*	50	23¼	1000	23¼-23⅝
20	Darke	300	24⅛		
24	Clayton	400	23⅞		
24	Holyk (or wife)			200	24⅛
24	Miller*			200	23¾
25	Miller*			300	23⅝-23½
26	Holyk (or wife)			200	23⅜
26	Huntington	50	23¼		
27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar 2	Holyk (Mrs.)	200	22⅜		
3	Clayton	100	22¼		
3	E. W. Darke*			500	22½-22⅝
16	Huntington			100	22⅜
16	Holyk (or wife)			300	23¼
17	Holyk (Mrs.)	100	23⅞		
17	E. W. Darke*			200	23⅜
23	Darke			1000	24¾
26	Clayton	200	25		

Purchase Date	Purchaser	Shares Number	Shares Price	Calls Number	Calls Exercise Price
LAND ACQUISITION COMPLETED MARCH 27, 1964					
Mar 30	Atkinson*			400	25¾-25⅞
30	Caskey*	100	25⅞	1000	25¾-25⅞
30	Darke			1000	25½
30	E. W. Darke*			200	25½
30	Holyk (Mrs.)	100	25⅞		
30-31	Klotz*			2000	25½-26⅛
30	Miller*			500	25½-25⅞
30	Westreich*	500	25¾		
CORE DRILLING OF KIDD 55 SEGMENT RESUMED MARCH 31, 1964					
Apr 1	Clayton	60	26½		
1	Fogarty	400	26½		
2	Clayton	100	26⅞		
6	Fogarty	400	28⅛-28⅞		
8	Mollison (Mrs.)	100	28⅛		
421 FEET KIDD-55-4 COMPLETED APRIL 9, 1964, 7 P.M.					
TGS PRESS RELEASE ISSUED APRIL 12, 1964					
Apr 15	Clayton	200	29⅜		
16	Crawford (and wife)	600	30⅛-30¼		
TGS PRESS RELEASE AND PRESS CONFERENCE APRIL 16, 1964, 10 A.M.					
Apr 16	Coates (for family trusts)	2,000	31-31⅝		
16	Haemisegger**	300	32½		
16	Robt. L. Armstrong**	200	31¼-34½		
16	Charles Callery**	300	32½		
16	James A. Baker III**	200	32⅝		
16	Malcolm G. Baker Jr.**	500	34½-35		
16	Morgan Guaranty Trust Co.***	10,000	32⅝-34		
16	Lamont and family****	3,000	34½		

* Darke visited Mrs. Caskey and her daughter Miss Atkinson in Washington between Dec. 25 and Dec. 30, 1963 and recommended TGS. They in turn recommended TGS directly or indirectly to others marked with *, with the exception of E. W. Darke, Darke's brother, who purchased calls on Darke's recommendation.

** Purchased by Haemisegger, Coates' son-in-law, for himself and customers (**) following telephone call from Coates before 10:20 a.m.

*** Purchased for its customers' accounts following call from Lamont to Hinton at about 10:40 a.m.

**** Purchased through Morgan Guaranty Trust Co. after 12:33 p.m.

(5456) THE SECURITIES EXCHANGE ACT OF 1934 (THE ACT) AND RULE 10B-5

The Commission has instituted this action pursuant to Section 27 of the Act (15 U.S.C. 78aa) which confers upon the District Courts of the United States exclusive jurisdiction of violations of the Act or of the rules and regulations promulgated thereunder and of "all suits in equity and actions at law brought to enforce any liability or duty created by" the Act or the rules and regulations thereunder.

The preamble of the Act states that it is "to provide for the regulation or securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."

Section 2 (15 U.S.C. 78b) provides that:

> ". . . transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, . . . and to impose requirements necessary to make such regulation and control reasonably complete and effective, (5457) in order to protect interstate commerce . . . and to insure the maintenance of fair and honest markets in such transactions. . . ."

Section 2(2) (15 U.S.C. 78b(2)) provides:

> "The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold. . . ."

Section 2(3) (15 U.S.C. 18b (3)) states that:

> "Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control. . . ."

Section 4(a) (15 U.S.C. 78d(a)) provides for the establishment of the Commission as the agency charged with the administration of the Act.

Section 10 of the Act (15 U.S.C. 78j) provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • • • •
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

(5458) Pursuant to the authority conferred on the Commission by Section 10(b), in May, 1942 the Commission

promulgated Rule 10b-5 (17 C.F.R. 240; 10b-5), which provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

In Rule 10b-5 the Commission adapted the language of Section 17(a) of the Securities Act of 1933 (15 U.S.C. 77q) relating to fraudulent interstate transactions. Similar language was also used in Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6).[6]

The Commission has the responsibility of administering the Act and of securing compliance therewith. To carry out this responsibility, it has been given, among other powers, authority under Sections 21(e) and 27 (15 U.S.C. 78u, 78aa) to institute actions in the district courts to (5459) enjoin existing or prospective violations of the Act and to enforce any liability or duty created by the Act or the rules and regulations promulgated pursuant thereto. The Commission contends that the defendants engaged in a "course of

business" which operated "as a fraud or deceit" on the stockholders of TGS in violation of Section 10(b) and Rule 10b-5.[7]

The defendants assert that the Commission must establish the elements of common law fraud—misrepresentation or nondisclosure, materiality, scienter, intent to deceive, reliance, and causation—citing decisions in private actions brought under Section 10(b) requiring proof of one or more of these traditional elements as a condition precedent to relief. *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783, 786 (2d Cir. 1951) ("proof of fraud is required in suits under §10(b) of the 1934 Act. . . ."); *Weber* v. *C.M.P. Corporation*, 242 F. Supp. 321, 324 (S.D.N.Y. 1965) (scienter); *Barnett* v. *Anaconda Company*, 238 F.Supp. 766, 771 (S.D.N.Y. 1965) (causation). See, Comment, "Civil Liability Under Section 10(b) and Rule 10b-5: A Suggestion for Replacing the Doctrine of Privity," 74 *Yale L. J.* 658 (1965).

(5460) However, recent decisions, even in private suits, do not require proof of these elements in actions charging violations of Rule 10b-5. *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210 (9th Cir. 1962); *Ellis* v. *Carter*, 291 F. 2d 270 (9th Cir. 1961). In *Stevens* v. *Vowell*, 343 F. 2d 374, 379 (10th Cir. 1965), the court stated:

> "It is not necessary to allege or prove common law fraud to make out a case under the statute and rule. It is only necessary to prove one of the prohibited actions such as the material misstatement of fact or the omission to state a material fact."

In a regulatory or enforcement proceeding under Section 27 of the Act, the Commission is not required to prove these common law elements. In *S.E.C.* v. *Capital Gains Bureau*, 375 U.S. 180 (1963), the defendant was an invest-

ment advisor who published a monthly report, mailed to approximately 5,000 customers, which recommended certain securities for long term investment. Before mailing the report, the defendant would purchase the recommended securities on the market and when the price rose after customers received the report, defendant would sell at a profit. The Commission sought an injunction under Section 206 of the Investment Advisers Act of 1940 (15 U.S.C. 80b-6) (8) (5461) to compel defendant to disclose this practice to customers. The district court denied a preliminary injunction on the ground that "fraud" was used in the Investment Advisers Act of 1940 in its technical common law sense and that the Commission had failed to establish an intent to injure clients or an actual loss to clients. (191 F. Supp. 897, 898.) The Second Circuit Court of Appeals, sitting *en banc,* affirmed the district court by a 5-to-4 vote. (306 F. 2d 606.)

In reversing, the Supreme Court held that:

> "It would defeat the manifest purpose of the Investment Advisers Act of 1940 for us to hold, therefore, that Congress, in empowering the courts to enjoin any practice which operates 'as a fraud or deceit,' intended to require proof of intent to injure and actual injury to clients. (375 U.S., at 192.)
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> "Congress intended the Investment Advisers Act of 1940 to be *construed like other securities legislation* 'enacted for the purpose of avoiding frauds,' not technically and restrictively, but flexibly to effectuate its remedial purposes. (375 U.S., at 195.) (Emphasis supplied)

Since there is a direct parallel between the language of Rule 10b-5(3) and Section 206 of the Investment Advisers Act of 1940, both in wording and in intent, the use of "fraud" in Rule 10b-5(3) cannot be interpreted in its narrow common (5462) law sense. *Cf., Berko* v. *Securities and Exchange Commission,* 316 F. 2d 137 (2d Cir. 1963).

The suggestion made by the defendants that Section 16 of the Act (15 U.S.C. 78p), relating to directors, officers, and principal stockholders, defines "insiders" and limits the liabilities of insiders to the sanctions provided in Section 16, is equally without merit. A Section 16 action can be brought only by the corporation itself or derivatively by an existing security holder against officers, directors or beneficial owners of ten per cent or more of the corporation's listed equity securities. It covers only short-swing profits realized within a six-month period, and any recovery inures to the corporation. Profits are recoverable regardless of any intent to defraud and without proof that they were realized by reason of inside information. In short, Section 16 was enacted as a "crude rule of thumb" to make unprofitable all short-swing speculation by a specifically defined group of insiders. See, *Blau* v. *Lamb,* F. 2d (2d Cir., June 27, 1966).

A Section 10(b) action, on the other hand, may be brought pursuant to Section 27 by the Commission or by any party claiming to have been defrauded. The section (5463) applies to "any person," not merely to the persons encompassed by Section 16. *H. L. Green Co.* v. *Childree,* 185 F. Supp. 95 (S.D.N.Y. 1960) (accountants); *Cady, Roberts & Co.,* 40 S.E.C. 907 (1961) (broker). Section 16 requires both a purchase and a sale of a listed security, while Section 10(b) applies to a purchase or sale of any security. The numerous differences between Section 16 and Section

10(b) clearly indicate that the provisions of the former impose no limitation on the enforcement of the latter. See, 3 Loss, *Securities Regulation,* 1473, 1474 (2d ed. 1961); Comment, "The Prospects for Rule X-10B-5: An Emerging Remedy for Defrauded Investors," 59 *Yale L. J.* 1120, 1140-42 (1950).

To establish violations of Section 10(b) and Rule 10b-5(3), the Commission must prove that the defendants engaged in a "course of business" which operated as a "fraud or deceit . . . in connection with the purchase or sale of any security." Questions arise therefore as to whether insider purchases based on material, undisclosed information constitute violations of Section 10(b) and Rule 10b-5(3); if so, who are insiders; whether the statute and rule are limited to "face-to-face" transactions; and, finally, what constitutes material information.

(5464) The statute and rule go at least as far as the federal common law rule. *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 461-2 (2d Cir. 1965). As long ago as 1909, the Supreme Court held in *Strong* v. *Rapide,* 213 U.S. 419 (1909), that the failure of the director and general manager of a corporation to disclose "special facts" in purchasing its securities operated as a fraud on the seller. The Court stated that:

> "If it were conceded, for the purpose of the argument, that the ordinary relations between directors and shareholders in a business corporation are not of such a fiduciary nature as to make it the duty of a director to disclose to a shareholder the general knowledge which he may possess regarding the value of the shares of the company before he purchases any from a shareholder, yet there are cases where, by reason of the special facts, such duty exists." 213 U.S., at 431.

Applying this "special facts" doctrine to Section 10(b) and Rule 10b-5, trading by an insider on the basis of material undisclosed information constitutes a deceptive practice in violation of the statute and rule. See, Loss, *supra*, at 1445-73.

In *Strong* v. *Rapide*, the defendant was a director and general manager of the corporation, and owned three-fourths of its outstanding shares. He was, therefore, an (5465) insider under any standard. Section 10(b) has been construed as imposing a similar liability on officers, directors, and major stockholders. *Cochran* v. *Channing Corporation*, 211 F. Supp. 239 (S.D.N.Y. 1962). Further, since Section 10(b) applies to "any person" it can include "insiders" who are not officers, directors or major stockholders. *Cady, Roberts & Co., supra*, at 912.

In *Brophy* v. *Cities Service Co.*, 70 A. 2d 5, 7 (Del. Ch. 1949), the court pointed out "if an employee in the course of his employment acquires secret information relating to his employer's business, he occupies a position of trust and confidence toward it, analogous in most respects to that of a fiduciary, and must govern his actions accordingly."

Citing *Brophy*, the Commission in *Cady, Roberts & Co., supra*, found that the obligation to disclose material information rests on two grounds:

> ". . . first, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, and second, the inherent unfairness involved where a party takes advantage of such information knowing that it is unavailable to those with whom he is dealing." 40 S.E.C., at 912.

(5466) Therefore, insiders subject to the disclosure requirements of Section 10(b) and Rule 10b-5 may include employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment.

An insider's liability for failure to disclose material information which he uses to his own advantage in the purchase of securities extends to purchases made on national securities exchanges as well as to purchases in "face-to-face" transactions. *List* v. *Fashion Park, Inc., supra,* at 461-62. In *Cochran* v. *Channing Corporation, supra,* at 243, the court stated:

> "The Securities Exchange Act was enacted in part to afford protection to the ordinary purchaser or seller of securities. Fraud may be accomplished by false statements, a failure to correct a misleading impression left by statements already made or, as in the instant case, by not stating anything at all when there is a duty to come forward and speak. It is the use of inside information that gives rise to a violation of Rule 10b-5. [Citations omitted.] Lack of communication between defendant and plaintiff does not eliminate the possibility that Rule 10b-5 has been violated."

And, as noted in *Cady, Roberts,* "it would be anomalous indeed if the protection afforded by the anti-fraud provisions were withdrawn from transactions effected on exchanges, (5467) primary markets for securities transactions." 40 S.E.C., at 914.

In response to the defendants' contention that it would be impossible for an insider trading on a national exchange

to seek out the other party to the transaction and disclose material information to him (*Goodwin* v. *Agassiz*, 186 N.E. 659 (Mass. 1933)), it is clear that there are other ways of disclosing significant corporate developments. The New York Stock Exchange provides in its *Company Manual* that "important developments which might affect security values or influence investment decisions should be promptly disclosed." (Listing Agreement at A-20.) If legitimate business reasons require a period of non-disclosure, the insider should forego transactions in his company's securities during that period. *Cady, Roberts, supra,* at 911. As stated by the court in *Oliver* v. *Oliver,* 45 S.E. 232, 234 (Ga. 1903):

> "It might be that the director was in possession of information which his duty to the company required him to keep secret; and, if so, he must not disclose the fact even to the shareholder, for his obligation to the company overrides that to an individual holder of the stock. But if the fact so known to the director cannot be published, it does not follow that he may use it to his (5468) own advantage, and to the disadvantage of one whom he also represents. The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be made known."

However, to establish a violation of Section 10(b) and Rule 10b-5, the undisclosed information must be material. *List* v. *Fashion Park, Inc., supra.* There is nothing in the Act which precludes insiders from purchasing stock of their company or from being beneficiaries of the company's incentive stock option plan. On the contrary, it is important,

under our free enterprise system that insiders, including directors, officers, and employees, be encouraged to own securities of their company. The incentive that comes with stock ownership benefits both the company and its stockholders.

Moreover, it is obvious that any director, officer, or employee will know more about his company or have more specialized knowledge as to at least some phase of its business than an outside stockholder can have or expect to have. Often this specialized knowledge may whet the speculative interest of the insider, particularly if he believes in the future of his company, and may lead him to purchase stock. Purchases under such circumstances are not encompassed by Section 10(b) and Rule 10b-5. As stated (5469) in Loss, *supra*, at 1463:

> ". . . an insider is under no obligation to give the ordinary investor the benefit of his superior financial analysis. It has been aptly said that, 'Even though a shrewd guess by an insider is often worth fifty accounting statements, it would be highly unfair to make him publicize his guess and then to hold him responsible if it turns out to be wrong.' " (Quoting, Comment, "The Prospects for Rule X-10b-5," 59 *Yale L. J.*, at 1148.)

However, where an insider comes into possession of *material* information which he uses to his own advantage by purchasing stock or calls on the stock of his company prior to public disclosure, he violates Section 10(b) and Rule 10b-5. Information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street. Material information has been defined as information "which in reasonable and objective contemplation

might affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra,* at 462, citing, *Kohler* v. *Kohler Co.,* 319 F. 2d 624, 642 (7th Cir. 1963). It is information which, if known, would clearly affect "investment judgment," *Cady, Roberts, supra,* at 911, or which directly bears on the intrinsic value of a company's stock. See, *Kardon* v. *National Gypsum Co.,* 73 F. Supp. 798 (E.D. Pa. 1947); *Speed* v. *Transamerica Corp.,* 99 F. Supp. 808 (5470) (D. Del. 1951); *Ward LaFrance Truck Corp.,* 13 S.E.C. 373 (1943).

Material information need not be limited to information which is translatable into earnings, as suggested by defendants. But the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight. As stated by a former member of the staff of the Commission:

> "It is appropriate that management's duty of disclosure under rule 10b-5 be limited to those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed. A more rigorous standard would impose an unreasonable burden on management in its securities trading. Moreover, such a standard could involve the courts to an unrealistic degree in the determination of whether certain types of information might have an impact on the market. A finer web might well prevent some management trading that represents an abuse, but only at the cost of possibly exposing management to meritless litigation in many other cases." (Fleischer, 'Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur* Proceeding,' 51 *Va. L. Rev.* 1271, 1289 (1965).)

(5471)

APPLICATION OF SECTION 10(b) OF THE ACT AND RULE 10b-5 TO PURCHASES BY INDIVIDUAL DEFENDANTS

All of the individual defendants were directors, officers or employees of TGS. With the exceptions of Stephens and Kline, each purchased stock of TGS using the facilities of a national securities exchange. Accordingly, the jurisdictional requirements of the Act and Rule 10b-5 have been satisfied with respect to these purchases. The issue remains as to whether any of the defendants in purchasing TGS stock or calls on TGS stock were using for their own advantage material information as to the drilling on the Kidd 55 segment not disclosed to the public. Defendants Huntington and Murray had no detailed knowledge as to the work and hence were not in possession of material information. Huntington knew only that TGS was acquiring property rights in Kidd Township. Murray had no knowledge of the situation on the Kidd 55 segment at the time he made his purchases. In considering whether the remaining individual defendants were in possession of material information when they made their purchases, the period from November 12, 1963 to April 16, 1964 may be conveniently subdivided as follows:

(1) November 12, 1963 to 7:00 p.m. April 9, 1964

(2) 7:00 p.m. April 9 to 10:00 a.m. April 16, 1964

(3) April 16, 1964 from 10:00 a.m. to the close of business on that day.

(5472)

(1) *November 12, 1963 to 7:00 p.m. April 9, 1964*

K-55-1 was completed on November 12, 1963. Visual estimates at the drill site, which were subsequently confirmed

by chemical assays received in mid-December, indicated substantial zinc and copper mineralization over approximately 600 feet of the core's 657 foot length. On the basis of the visual estimates, TGS took customary security measures to maintain the secrecy of the drilling results while it undertook to acquire the remaining quarter sections of the Kidd 55 segment. On March 31, 1964 drilling was resumed.

K-55-3 was drilled and established that mineralization existed in a vertical plane over 350 feet wide and 500 feet deep. On April 7 drilling of K-55-4 was begun 200 feet south of K-55-1 and by 7:00 p.m. on April 9 it had been drilled to 421 feet and had encountered 366 feet of mineralization. K-55-1, K-55-3, and K-55-4 intersected substantial copper mineralization on the eastern edge of the anomaly.

According to the Commission's experts, Adelstein[9] (the Commission's chief mining engineer) and Pennebaker (consulting geologist to the Commission), K-55-4 established a third dimension to the mineralized zone, so that the (5473) drilling through 7:00 p.m. on April 9 established a mine.[10]

The geologists called by the defendants disputed the conclusions reached by Adelstein and Pennebaker, unanimously agreeing that the drilling of the three holes to 7:00 p.m. on April 9 did not establish that TGS had a mine. The Commission has taken the position with respect to registration statements filed under the Securities Act of 1933 that "three diamond drill holes are insufficient to determine whether a commercial ore body is present, even though they should encounter a gold bearing structure." *Pan-American Gold Ltd.*, 31 S.E.C. 141, 147-8 (1950).

It is unnecessary to determine whether TGS had a mine since the drilling of K-55-4 to 7:00 p.m. on April 9 was a strong indication that the mineralization encountered on the vertical plane between K-55-1 and K-55-3 extended southward 200 feet. There was real evidence that a body

of commercially mineable ore might exist. At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock. Therefore, they were under a duty not to use such material information to their personal advantage without first disclosing it to the public.

(5474) However, the drilling results up to 7:00 p.m. on April 9 did not provide such material information. When considered in relation to the far-flung business of TGS at the time, it cannot be said that the drilling results of K-55-1 and K-55-3 constituted material information, the disclosure of which would have had a substantial impact on the market price of TGS's 10,000,000 outstanding shares.

K-55-1

There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it. However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body. Concededly, the geophysical survey conducted prior to the drilling of K-55-1 indicated a "first class" anomaly over a length of more than 1,000 feet, but the conductive materials evidenced by the survey outside the first drill hole could have consisted of worthless pyrite or graphite, both of which materials were found in the core of K-55-1. As stated by Boniwell, a mining geophysicist, (5475) geophysics is of little help in predicting continuity.

Moreover, the core of K-55-1 was not solid ore. The percentages of copper and zinc mineralization fluctuated

markedly. Although it appears this is not unusual due to the complex nature of the Pre-Cambrian subsurface rock structure, it supports the testimony of defendants' experts that no predictions could be made as to how far mineral values encountered by K-55-1 extended beyond the 1⅛ inch drill core. As was brought out by Walkey, a mining engineer employed by Kamkotia Mines 12 miles from the Kidd 55 segment, mineral deposits on the Canadian Shield tend to be highly irregular in structure, with wide variations in grade. Walkey, Boniwell and Wiles (a mining engineer with forty years' experience) testified as to instances where one drill hole had produced a promising core but subsequent drilling had shown that the mineral values did not extend any appreciable distance beyond that core. Therefore, the first promising core may turn out to be a liability by inducing further drilling with negative results.[11]

Bellemore and Pearson, security analysts called by defendants, testified that from an investment point of (5476) view no significance could be attached to the results of a single drill hole, however rich.

The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had "hopes, perhaps with some reason," that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too "remote" when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, *i.e.*, to be deemed material. *List* v. *Fashion Park, Inc., supra.*

The Commission contends, however, that the results of K-55-1 were material because of the significance attached to

those results by certain defendants. Between the completion of K-55-1 on November 12, 1963 and the completion of K-55-3 on April 7, 1964, defendants Fogarty, Mollison, Holyk, Clayton and Darke spent more than $100,000 in purchasing stock and calls on the stock of TGS. These defendants could bring considerable expertise to bear in evaluating the results of K-55-1 and their purchases may have been prompted by an educated guess that K-55-1 would (5477) lead to the discovery of a mine. Therefore, a question is presented as to whether information which may have special significance to an insider because of his professional background, is material.

A similar question would be presented where an engineer in the research department of a publicly-held corporation believes that he may have invented a process which will substantially increase the corporation's earnings or where a chemist in a large pharmaceutical firm thinks that he may have devised a chemical formula which can cure cancer. In these instances it can be assumed that the insider, because of his educated guess, will be enthusiastic and his enthusiasm may lead him to purchase stock in his company and to recommend the stock to his associates and friends even though his educated guess may turn out to be wrong. It may be argued that such purchases are "unfair" to the outside stockholders and come within the ambit of Section 10(b) and Rule 10b-5. Purchases on the basis of educated guesses may be viewed as an attempt to secure additional corporate compensation. Cary, "Corporate Standards and Legal Rules," 50 *Calif. L. Rev.* 408 (1962).

(5478) However, most insiders necessarily have educated guesses about the prospects of particular company programs. If it is held that purchases made on the basis of educated guesses are proscribed by Section 10(b) and Rule

10b-5, insiders who purchase stock in their company will do so at their peril. If they announce their educated guesses before purchasing and their guesses turn out to be wrong, they would be subject to suit; and if they purchase and keep their educated guesses to themselves and they turn out to be right, they would again be subject to suit. The creation of such a dilemma would result in insiders not buying at all although insiders should be encouraged to have a stake in the companies for which they work.

The outside stockholder can never match the knowledge of an insider who necessarily knows more about the company and is in a better position to evaluate its prospects. It may be that the "fairness" overtones of *Cady, Roberts* indicate a trend toward the elimination of all insider purchasing. But even were the Court prepared to accept the proposition that all insider trading is unfair, a proposition of doubtful validity at best, it would be deterred by the admonition of Judge Learned Hand that it is not "desirable for a lower (5479) court to embrace the exhilarating opportunity of anticipating a doctrine which may be in the womb of time, but whose birth is distant. . . ." *Spector Motor Service Inc.* v. *Walsh,* 139 F. 2d 809, 823 (2d Cir. 1944) (dissenting opinion) (reprinted in Bar Bulletin, N. Y. Co. Lawyers Assn, Vol. 23, No. 4, at 156, 1965-66). Therefore the purchases prior to 7:00 p.m. on April 9 were not based on material undisclosed information even if the purchasers had educated guesses based on the results of the first drill hole.

K-55-3

K-55-3 established that K-55-1 had not gone down dip, and indicated a vertical plane on section 2400 S containing mineralization. However there was no indication that the

mineralization extended beyond the plane. Defendant Mollison testified that at Kamkotia a drill hole could produce substantial mineralization while another 50 feet away produced a barren core. The results of K-55-3 added to the information previously known but did not constitute material information. If disclosed, it would not have had a substantial impact on the market price of the Company's stock.

Accordingly, the purchases made by certain defendants prior to 7:00 p.m. on April 9, 1964 were not based (5480) on material information. The fact that subsequent drilling established a major ore body is immaterial. As stated recently in *Value Line Fund, Inc.* v. *Marcus,* CCH FED. SEC. L. REP. ¶91,523,, at 94,956 (S.D.N.Y. 1965), "the court must be guided not by hindsight, but by the facts as they existed at the time of the . . . challenged transaction."

Similarly, purchases by Darke's "tippees" prior to 7:00 p.m. on April 9 were not made on the basis of material undisclosed information. Toward the end of December, 1963, Darke visited Caskey and Atkinson in Washington. The evidence shows no more than that Darke indicated to them that he thought TGS was a good buy. There is no direct evidence that Darke again communicated with any of his "tippees," but the record shows that on March 30, 1964 Darke and his "tippees," Atkinson, Caskey, E. W. Darke, Klotz, Miller and Westreich, purchased substantial amounts of TGS stock and calls on TGS stock. As the Commission points out, this is strong circumstantial evidence that Darke must have passed the word to one or more of his "tippees" that drilling on the Kidd 55 segment was about to be resumed. But, for the reasons hereinbefore stated, this information was not material.

(5481) For the foregoing reasons, the Court finds no violations of Section 10(b) or Rule 10b-5 on the part of any of the individual defendants who purchased shares of TGS or calls on TGS stock or recommended such purchases to others prior to 7:00 p.m. on April 9, 1964.

(2) *7:00 p.m. April 9, 1964 to 10:00 a.m. April 16, 1964*

Defendant Clayton purchased 200 shares of TGS stock on April 15; defendant Crawford purchased 600 shares on April 16. These defendants (and defendants Coates and Lamont) raise the defense that even if they were in possession of material information when they made their purchases, the material information had already become a matter of public knowledge.

The trial developed that rumors of an ore discovery by TGS were flying around Canada during the early part of April and were being given wide circulation in the Canadian press. These rumors reached the New York press by April 11, on which day they were played up in both the *New York Times* and the *New York Herald Tribune*. At this point defendants Stephens and Fogarty agreed that a press release was necessary and this decision led to the issuance of the April 12 press release hereafter discussed. Fogarty (5482) also gave instructions that a reporter from *The Northern Miner* (an important Canadian publication on the mining industry in Canada), who had previously been invited to visit the Kidd 55 segment on April 21, be asked to come on April 13 instead.

The Northern Miner reporter, Ackerley, visited the property on April 13, interviewed defendants Mollison, Holyk and Darke, looked at the records of the drilling to that time, and prepared an article for publication. The article stated in part that "The Northern Miner can say that a

major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation . . . something in excess of 10,000,000 tons of ore is indicated." Ackerley delivered a copy of his proposed article to defendant Mollison in Timmins and it was agreed that it would not be published until cleared by Mollison. Defendants Mollison and Holyk read the article and though they felt that some of its conclusions were too optimistic, they considered it Ackerley's article and would not quibble with it. Defendant Mollison returned the article to *The Northern Miner* on the evening of April 15, and it was published in *The Northern Miner's* April 16 edition.

(5483) *The Northern Miner* had a small circulation in the United States—7,400 subscribers—including distribution in the New York area to 1,412 subscribers, who presumably received the paper on the morning of April 16. *The Northern Miner* also had a small newsstand circulation in New York, but the evidence fails to establish when the April 16 edition reached the newsstands. Reports of *The Northern Miner* article were telephoned and telexed from Toronto to some brokers in New York early on the morning of April 16 prior to the opening of the New York Stock Exchange.

The annual convention of the Canadian Institute of Mining and Metallurgy was held at the Queen Elizabeth Hotel in Montreal on April 13-15, attended by 500 to 600 representatives of the mining industry and of the business world, including some representatives from the United States. The rumors with respect to a copper discovery by TGS near Timmins were a leading subject of gossip in the corridors and bars of the hotel. The convention was attended by the Ontario Minister of Mines and his Deputy.

On the morning of April 15, defendants Mollison and Holyk met the Minister of Mines and his Deputy at the (5484) Montreal airport and flew them to Toronto, informing them during the course of the flight of the current developments on the Kidd 55 segment. The Minister indicated a desire to make a public statement and Mollison assisted him by drafting that statement. Mollison's draft concluded by saying that "the information now in hand . . . gives the company confidence to allow me (the Minister) to announce that TGS has a minable body of Zn, Cu, Ag ore of substantial dimensions that will be developed and brought to production as rapidly as possible." Mollison and Holyk were under the impression that the Minister would issue the statement in Toronto over radio and television at 11:00 p.m. on the evening of April 15 and Mollison so informed defendants Stephens and Fogarty in New York.

The Minister made no announcement on the evening of the 15th, but on the morning of the 16th, at about 9:40 a.m., he delivered the statement drafted by Mollison to the press gallery at the Ontario Parliament in Toronto. Members of the press gallery included representatives of both the Canadian and American news media, but there was no evidence as to who was in the press gallery at the time.

The effect of the foregoing was that before the market opened on April 16, some brokers and some speculators (5485) had picked up information that TGS had made an ore discovery. However, no announcement had yet been made by TGS. Only the day before, defendants Stephens, Fogarty and Crawford were preparing the announcement which was to be made at 10:00 a.m. on April 16. They took steps to assure the attendance of appropriate representatives of the news media at the press conference where the announcement would be made. The officers of TGS knew

about the rumors in Canada, the *Northern Miner* article and the pending announcement of the Ontario Minister of Mines. Had they thought that their effect was to make the material information public there would have been little purpose in making the arrangements for a press conference, and issuing a detailed announcement on April 16. The material information did not become public knowledge prior to TGS's official announcement. Therefore, insiders who purchased stock prior to TGS's announcement may not assert as a defense that the material information had already become a matter of public knowledge.

Turning now to the two defendants who purchased shares of TGS after 7:00 p.m. on April 9, 1964 and before 10:00 a.m. on April 16:

Richard H. Clayton

Clayton was a geophysicist in the employ of TGS. His job was to conduct geophysical surveys, and he conducted such surveys on the Kidd anomaly. While he did not participate (5486) in the drilling, he spent a great deal of his time at Timmins and at the Kidd 55 segment, and the evidence establishes that he kept himself fully informed. He was in Timmins on April 12 and 13 and, according to Adelstein, he told Adelstein (on June 3, 1964) that he thought TGS had a mine when he learned the results of K-55-4. While Clayton denied making this statement, he testified at a pre-trial examination that he thought that, with the results of K-55-6, TGS had a potential ore body. By 7:00 p.m. on April 13, K-55-6 had been drilled to 949 feet, encountering substantial mineralization. Indeed, no further mineralization was encountered by K-55-6 after that time. On April 14 Clayton left for New York and was in TGS's New York

office on April 15. He picked up the telephone at TGS's office in New York, called his broker in Toronto and ordered 200 shares of TGS stock. The broker executed the order on April 15 on the Midwest Stock Exchange in Chicago at 29⅜.

It is clear that at the time of this purchase Clayton was in possession of material inside information which had not yet been made available to the public and that he used this information to his own advantage. In this proceeding by the Commission it is immaterial whether (5487) Clayton intended to deceive or to defraud anyone or whether he knew at the time that his purchase would violate Section 10(b) and Rule 10b-5. The Commission has established that Clayton violated these provisions in making his April 15 purchase.

Clayton contends that he is not subject to the jurisdiction of this court. He was employed by TGS, a United States corporation, and, according to his testimony, shuttled back and forth between Canada and New York on TGS business during the period from November 1963 to April 1964. His April 15 purchase was initiated by him while he was in New York in TGS's office. He placed his order with his Toronto broker by telephone from New York to Canada, employing a channel of interstate and foreign commerce. The transaction was consummated on the Midwest Stock Exchange in Chicago. He had previously purchased TGS stock, and on two occasions his orders were executed on the New York Stock Exchange. Though he placed his orders with a Toronto broker, all his purchases were effected on an American stock exchange. Clayton's telephone call from New York on April 15 brought about the purchase. Therefore, the court has subject matter jurisdiction. (Section 27 of the Act, (5488) 15 U.S.C. 78aa; *Ferraiola* v. *Cantor,* CCH FED. SEC. L. REP. ¶91,704 (S.D.N.Y. 1966)). Under Sec-

tion 27 Clayton could be served wherever he was found and service outside of the United States has been sustained. *Ferraiola* v. *Cantor, supra; S.E.C.* v. *VTR Inc.*, CCH FED. SEC. L. REP. ¶91,618 (S.D.N.Y. 1966); *S.E.C.* v. *Briggs*, 234 F. Supp. 618 (N.D. Ohio 1964); see Advisory Committee's Note to the 1963 revision of Rule 4 of Fed. R. Civ. P. reprinted at 31 F.R.D. 627, 630 (1962). Service upon Clayton by leaving the summons and complaint with his wife at his home in Timmins was valid. (Rule 4(d)(1), (e), (f), Fed. R. Civ. P.)

DAVID M. CRAWFORD

Crawford is a lawyer who came with TGS on February 20, 1964, on which date he was appointed secretary of the Company and manager of its public and Government relations. He had not been informed as to the developments on the Kidd 55 segment. He read the rumor article in the *New York Herald Tribune* on April 11 while on his way to Houston to prepare for TGS's annual stockholders' meeting. He returned to New York either late on the 14th or early on the 15th of April, and on that day participated with Fogarty (5489) and a representative of Doremus & Co. in the preparation of the April 16 press release. The evidence establishes that by the evening of April 15 he was fully familiar with the contents of the announcement which was to be made the following morning. He spent the night in a room maintained by TGS at the Drake Hotel in New York City. About midnight he telephoned his broker in Chicago and ordered 300 shares of TGS for himself and his wife to be purchased as soon as the market opened the following day. During the night he decided to increase his order, and he telephoned his broker again at about 8:30 a.m. on April 16 to increase the order from 300 shares to 600 shares. The purchase was

executed on the Midwest Stock Exchange on April 16 at 30⅛ to 30¼.

Here again, while there is no evidence that Crawford intended to deceive or to defraud anyone, it is clear that he sought to, and did, "beat the news." There is no doubt that he believed that he could get the stock more cheaply if he bought before TGS's announcement was made. In so doing, he was utilizing material undisclosed information to his own advantage and violated Section 10(b) and Rule 10b-5. (5490)

(3) *10:00 a.m. April 16 to Close of Business on that Day*

Between the announcement and the close of business on April 16 defendants Coates and Lamont either purchased shares of TGS or recommended their purchase to others.

A regular meeting of the Board of Directors was held at TGS's offices at 9:00 a.m. on April 16. During the meeting defendant Stephens distributed copies of the announcement to be made to the press at the press conference called for 10:00 a.m. Stephens also told the Board that a statement regarding TGS's discovery had been issued in Toronto at 11:00 p.m. the previous evening by the Ontario Minister of Mines. At the conclusion of the Directors' meeting, representatives of the news media, over 22 in all, came into the Board Room. The announcement was made by Stephens, and they were given copies of the press release which Stephens, Fogarty and Crawford had prepared. The press release stated in part:

> "Texas Gulf Sulphur Company has made a major strike of zinc, copper and silver in the Timmins area of Ontario, Canada.
>
> • • • • •

"Seven drill holes are now essentially complete and indicate an ore body of at least 800 feet in length, 300 feet in width and (5491) having a vertical depth of more than 800 feet.

• • • • •

"This is a major discovery. The preliminary data indicate a reserve of more than 25 million tons of ore. The only hole assayed so far represents over 600 feet of ore, indicating a true ore thickness of nearly 400 feet.

• • • • •

"Visual examination of cores from the other holes indicate comparable grade and continuity of ore.

"The ore body is shallow, having only some 20 feet of overburden. This means that it can easily be mined initially by the open pit method."

• • • • •

Summaries of the announcement were carried over the internal news wire of Merrill Lynch, Pierce, Fenner & Smith at 10:29 a.m., and over the Dow Jones broad tape between 10:54 a.m. and 11:02 a.m.

FRANCIS G. COATES

Coates was a Houston lawyer and a member of the Board of Directors of TGS. After reading the *Herald Tribune* article of April 11 he telephoned defendant Stephens from Houston and was told by Stephens that TGS did not have (5492) enough information to know what it had. Coates

came to New York on April 15 and saw a draft of the proposed April 16 announcement that afternoon. On the 16th he attended the Directors' meeting and remained for the press conference at which the announcement was made. The press conference started at 10:00 a.m. and lasted ten or fifteen minutes. Shortly before 10:20 a.m. Coates left the meeting room and telephoned his son-in-law, Haemisegger, a broker in Houston. He told Haemisegger of TGS's discovery and ordered 2,000 shares of TGS stock for the accounts of four family trusts of which he was a trustee but not a beneficiary. Haemisegger executed the order at prices from 31 to 31⅝ on the New York and Midwest Exchanges. Haemisegger immediately imparted the information he had received from Coates to four of his customers, and they, as well as Haemisegger himself, purchased a total of 1500 shares of TGS stock at prices ranging from 31¼ to 35.

Coates lost no time in telephoning his son-in-law in order to purchase TGS stock for his family trusts. Coates could not, as could Lamont when he telephoned Hinton at the Morgan Guaranty Trust Company just before 10:40 a.m. assume "without thinking about it, that the [ore discovery] (5493) was already a matter of public information. . . ." *Cady, Roberts, supra,* at 917. The announcement had been made, however, and it has been the generally accepted rule that it is the making of the announcement that controls. For example, the Commission in *Cady Roberts* found violations of Section 10(b) and Rule 10b-5 for purchases made "during the time when respondents should have known that the board of directors . . . was taking steps to make the information publicly available but *before it was actually announced.*" *Cady, Roberts, supra,* at 915. (Emphasis supplied.) Coates, an experienced corporate lawyer, testi-

fied that he believed that the standard in the marketplace was that once the announcement is made, insiders were free to purchase stock or to recommend it to others.

It may be, as the Commission contends, that a more effective rule should be established to preclude insiders from acting on information after it has been announced but before it has been absorbed by the public. Perhaps such a rule should extend not only to corporate insiders but to others who may be in a position to take unfair advantage of the stockholders. What of a representative of the news media who, upon hearing the announcement, calls his broker before he calls (5494) his office? What of a wire house which has an inside track in getting the information to its registered representatives and to its customers? (The April 16 announcement went out over Merrill Lynch's news wire to its 145 offices half an hour before it went out over the Dow Jones ticker.) Should the representatives of the news media and the wire houses be subjected to such a rule since they are in possession of material information which the average stockholder has not had an opportunity to absorb? These examples are offered merely to illustrate the problems that arise if the present practice is to be changed.

The Commission took the position, on summation, that it is for the courts to fix a reasonable waiting period after an announcement is made, during which insiders cannot purchase stock, so that the announcement can first be absorbed by the public. In other words, it seems to be the Commission's position that a fairer practice than now exists should be evolved through court decisions. This could only lead to uncertainty. A decision in one case would not control another case with different facts. No insider would know whether he had waited long enough after an announcement had been made. He would be subject to suit by the Com-

mission (and to private (5495) suits brought by others riding on the Commission's coattails).

The Commission has not supplied, nor has the Court found, decisions specifying a waiting period after a corporate announcement is made. After this action was instituted, Cary, the former chairman of the Commission, and Fleischer, his former executive assistant, discussed a waiting period in policy terms.[12] If a waiting period is to be fixed, this could be most appropriately done by the Commission, which was established by Congress with broad rule-making powers. Should the Commission determine that it lacks authority to fix a waiting period, authority should come from Congress rather than from the courts.

Since TGS's announcement had been made when Coates telephoned Haemisegger, he did not violate Section 10(b) or Rule 10b-5.

Thomas S. Lamont

Lamont was a director of TGS. He was also a director of Morgan Guaranty Trust Company and a member of its Executive Committee and its Trust and Investment Committee. (5496) Lamont testified that he first heard of the exploration on the Kidd 55 segment on April 10 when defendant Stephens telephoned him about the rumors in Canada, and Lamont advised Stephens to ignore them unless they reached the New York press. Stephens informed Lamont that the exploration was "at the prospect stage."

Thereafter, Lamont heard rumors from friends and read the article which appeared in the *Herald Tribune* on April 11, and TGS's April 12 press release as reported in the press. On April 13 or 14 he had a conversation about the rumors with Hinton, the Executive Vice President of Mor-

gan Guaranty Trust Company. Lamont told Hinton that he knew nothing more than had appeared in the press. On April 15 Lamont was informed by Stephens that a press conference would follow the regular Directors' meeting scheduled for the morning of the 16th. Lamont attended the Directors' meeting and read the press release, and attended the press conference at which the announcement was made.

Following the announcement, and while he was still at the TGS office, Lamont telephoned Hinton about 10:40 a.m. and told Hinton that good news about TGS had come out or would be shortly coming out on "the tape." Immediately (5497) following Lamont's telephone call, Hinton telephoned his trading department and was informed that TGS stock was active and up three points. Hinton thereupon placed an order for 2,000 shares of TGS for the account of the Bank's customer, the Nassau Hospital, which order was executed at about 10:41 a.m. Thereafter, Hinton placed further orders for purchases of TGS stock for customers of the Bank, including pension trusts, purchasing a total of 10,000 shares at prices ranging from 32⅝ to 34. At about 12:30 p.m. on April 16 Lamont ordered the purchase of some 3,000 shares of TGS for himself and members of his family, which orders were executed at a price of 34½.

Lamont's telephone call to Hinton was made some 20 minutes after Coates telephoned his son-in-law, both calls being made after the announcement. His own purchases were ordered more than two hours after the announcement.

For the reasons previously stated with respect to defendant Coates, Lamont did not violate Section 10(b) or Rule 10b-5, since the announcement had been made.[13]

(5498) ***Stock Options issued by TGS to certain defendants on February 20, 1964.***

Five of the defendants—Stephens, Fogarty, Kline, Mollison and Holyk—are charged with violating Section 10(b) and Rule 10b-5 by accepting stock options voted to them on February 20, 1964 by the Directors' Committee to Administer the Restricted Stock Option Incentive Plan (the Committee).[14] The Commission contends that these defendants violated the statute and the rule because they had knowledge as to the drilling results of the first hole, K-55-1, which knowledge they failed to disclose to the Committee or to the Board of Directors prior to accepting their options.

TGS's restricted Stock Option Incentive Plan (the Plan) was inaugurated in 1961 with the approval of its stockholders.[15] Three non-management directors, John H. Hill, Leslie M. Cassidy and defendant Coates, were the members of the Committee appointed by the Board. At the meeting of the Committee held on February 20, 1964, two members, Hill and defendant Coates, were present. The minutes disclose that the Board of Directors at its meeting on March 16, 1961 had directed that no shares should be (5499) optioned to any employee earning less than $24,000 annually. The Committee granted stock options to 21 officers and employees earning $24,000 or more per annum (including defendants Stephens, Fogarty, Mollison and Kline) and recommended to the Board the granting of stock options to five employees (including defendant Holyk) whose annual salaries were in the $15,000 to $21,000 range, which recommendation was approved by the Board at its meeting later on the same day.

The use of stock option plans is a commonly accepted device to provide incentive to officers and employees. Restricted stock options of the type authorized by the stock-

holders of TGS are not uncommon in publicly-owned companies. As pointed out by Judge Weinfeld in *Kornfeld* v. *Eaton*, 217 F. Supp. 671, 677 (S.D.N.Y. 1963), *aff'd* 327 F. 2d 263 (2d Cir. 1964):

> " . . . Restricted stock options of the type here under consideration have their genesis in express approval by the stockholders of the corporation and are intended to enable its employees to benefit from an increase in the market value of the security. The corporate purpose is satisfied through the optionee's services and his efforts to further its interests. Indeed it is in the corporate economic interest that its employees have an investment stake in it. Congress itself has recognized the salutary purpose of such plans by extending them favorable tax treatment."

(5500) The Committee necessarily relied on information furnished it by the higher echelon of TGS's management (which would include defendants Stephens and Fogarty, but not Mollison, Kline or Holyk). The Committee did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management.

The record shows that at the time they accepted their stock options, each of the five defendants (except Kline) knew of the situation on the Kidd 55 segment as it existed at the time. Since the land acquisition program had not been complete they had been instructed not to divulge this information. Indeed, on February 20, 1964, neither the Board of Directors nor the Committee had been informed.[16]

Defendant Kline was informed by defendants Stephens and Fogarty at lunch in November 1963 that TGS was co-

ducting explorations in the Timmins area and that the completion of the first drill hole was a favorable development; that it was on the boundary of the TGS property and that TGS was interested in acquiring additional property. He knew no details and his only information came from his (5501) superiors. Defendants Mollison and Holyk knew the results of K-55-1 and had reported these results to their superior, defendant Fogarty. Kline, Mollison and Holyk had no duty to inform the Committee of information already known to their superiors since they could assume that such information would be reported to the Committee by the management.

Defendants Stephens and Fogarty as President and Executive Vice President were management. Both were also Directors and potential recipients of stock options. They were under a duty to inform the Committee of material information affecting the issuance of the stock options. The Plan required that the option price be at least 95% of the fair market value of the stock on the date on which the options are to be granted. The Committee fixed the option price as "the average of the highest and lowest prices of the Company's stock on the New York Stock Exchange during February 20, 1964." Therefore, included in Stephens' and Fogarty's duty of disclosure was any material information bearing on the market value of TGS stock on that date.

A corporate officer may be guilty of fraud if he withholds material information from his company to his own advantage. *New Park Mining Co.* v. *Cranmer,* 225 F. Supp. 261 (S.D.N.Y. 1963). Therefore, if the information known (5502) to defendants Stephens and Fogarty would have substantially affected the price of the TGS stock on the New York Stock Exchange, their receipt of stock options

without disclosure to the Committee could have constituted a fraud on TGS. A stock option is a security (the Act, Section 3(a)(10); 15 U.S.C. 78c(a)(10)), so that such a fraud would have come within the ambit of Section 10(b) and Rule 10b-5. See *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964).

On February 20, 1964, defendants Stephens and Fogarty knew (1) that K-55-1 had been completed; (2) that the drill core had been assayed and that the assay certificates showed substantial mineralization; and (3) that the land acquisition program was in progress and that further drilling would await its completion. However, the Court has already determined that the information as to developments on the Kidd 55 segment were not material until 7:00 p.m. on April 9, some seven weeks later. The same definition of materiality applies. Since the information was not material, defendants Stephens and Fogarty were not required to disclose it to the Committee. Hence, defendants Stephens and Fogarty were not guilty of fraud or deception in failing to furnish the information. In (5503) view of the land acquisition program, the security measures which they established were for the benefit of the Company and its stockholders.[17]

In accepting the stock options granted to them on February 20, 1964, defendants Stephens, Fogarty, Kline, Mollison and Holyk did not violate Section 10(b) or Rule 10b-5.

The April 12, 1964 Press Release

On Sunday, April 12, 1964, at about 3:00 p.m., TGS issued a press release, the substance of which appeared in the Monday morning newspapers. The text of the release stated in part:

"NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fegarty said:

" 'During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

" 'The facts are as follows. TGS has been exploring in the Timmins area for six (5504) years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

" 'Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

"'Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"'The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project.'"

• • • • •

(5506) The Commission argues that at the time the press release was issued, TGS knew that it had discovered a copper mine on the Kidd 55 segment and that the press release was materially misleading in characterizing this discovery as a "prospect" and in stating that "any statement as to size and grade of ore would be premature." For these reasons the Commission contends that the press release violated Section 10(b) and Rule 10b-5.

TGS denies that the press release was false or misleading. Moreover, TGS contends that no violation of Section 10(b) or Rule 10b-5 is made out by the Commission since the press release was not issued "in connection with the purchase or sale of any security." However, the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of a company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo*

Food Serv., Inc., CCH FED. SEC. L. REP. ¶91,317 (N.D. Ill. 1964). The phrase "in connection with the purchase or sale of any security" has been broadly construed "to carry out the intent of the Act, which is designed to protect investors against fraud." *Stockwell* v. *Reynolds & Co.*, (5507) CCH FED. SEC. L. REP. ¶91,579 at 95,198 (S.D.N.Y. 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (S.D.N.Y. 1964).

During the first week of April, rumors of a copper discovery by TGS on the Kidd 55 segment were circulating in Canada. These rumors intensified, and on April 9 Toronto newspapers reported that TGS had discovered "one of the largest copper deposits in North America," "a major copper strike." On April 10, defendant Stephens telephoned defendant Lamont seeking his advice as to what action TGS should take with respect to the rumors. Lamont advised that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release.

On Saturday morning, April 11, 1964, defendant Stephens, while at his home in Greenwich, Connecticut, read the articles appearing in the *New York Times* and the *New York Herald Tribune*. The *Herald Tribune* article announced that TGS had "the biggest ore strike since gold was discovered more than 60 years ago in Canada . . . a bed of copper sulphide 600 feet wide with a possible overall copper return of 2.87% through most of its width."; (5508) that TGS had four drill rigs in operation with four more to go into operation the following week; and that the richness of the copper was so great that it had been flown out of Canada to be assayed.

Stephens telephoned defendant Fogarty at the latter's home in Rye, New York and told him about the articles. Fogarty read the articles and called Stephens back. Fogar-

ty testified that he and Stephens "were quite upset . . . because certainly they [the articles] were full of exaggerations and what I considered to be erroneous statements." Stephens advised Fogarty that TGS should issue a press release to clarify the rumors, referring to his April 10 conversation with defendant Lamont. Stephens asked Fogarty to contact Carroll of Doremus & Co., the Company's public relations firm, who also lived in Rye. Fogarty did so, and Carroll agreed that TGS should issue a press release.

At about 1:00 p.m. on Saturday afternoon, April 11, Fogarty telephoned defendant Mollison at his home in Greenwich, Connecticut, and asked for a review of the situation at the Kidd 55 segment. At about 5:00 p.m. he went to Mollison's home to discuss the matter further. Mollison had been on (5509) the Kidd 55 segment on the morning of April 10 and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet.

In reporting the situation on the Kidd 55 segment, Mollison told Fogarty that the only known mineral occurrences in the area had been at Kamkotia and that these consisted of a series of small disconnected sulphide masses. Mollison advised that it was too early to state what TGS had and "it was impossible at that time . . . to understand the structure, to make the projections from one hole to another." Fogarty went home and drafted notes for a press release which he took to Carroll's house so that they could be put in shape by Carroll for release on Sunday, the following day. He had telephoned defendant Hunting-

ton, one of TGS's lawyers, reading his notes to him. Huntington made one or two suggestions and advised Fogarty that he thought the release would be all right legally.

(5510) On Sunday morning, April 12, Fogarty telephoned Mollison to see if he had any additional information, and instructed Mollison to return with Holyk to Timmins as soon as possible to "move things along." Fogarty and Carroll then completed the final draft of the press release at Carroll's house. Fogarty telephoned Stephens and read the final draft to him, Stephens asking certain questions and making minor changes. Stephens instructed Fogarty to have the release issued as promptly as possible so that it would be on the wires on Sunday afternoon.

From the foregoing, it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or (5511) Rule 10b-5 since it was not issued "in connection with the purchase or sale of any security."

However, even if it had been established that the April 12 release was issued in connection with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive. The significance of the drilling results known to TGS by 7:00 p.m. on April 10 was the subject of detailed and conflicting tes-

timony at the trial. Adelstein defined proven ore and probable ore. His definitions were substantially the same as the definitions used in the General Rules and Regulations under the Securities Act of 1933, Appendix I, Form 1-A, Notification Under Regulation A, Schedule I, Item 8A(c), which provide:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Based on these definitions and the drilling done to 7:00 p.m. on April 10, Adelstein was of the opinion that TGS could have calculated 8.33 million tons of proven ore. Pennebaker, (5512) the other Commission expert, was of the opinion that TGS could have calculated 6.2 million tons of proven ore. Both of the Commission experts stressed that the drilling showed substantial mineralization in the cores and substantial copper mineralization on the eastern edge of the anomaly. Since they could make estimates as to the size and grade of ore on the basis of information to 7:00 p.m. on April 10, the Commission contends that the use of the word "prospect" in the April 12 press release was misleading. Adelstein defined a "prospect" as a property where there is no assurance that commercially mineable reserves exist.

The opinions of Adelstein and Pennebaker were contradicted by Forrester, Park, Wiles, Walkey, Lacy and McLaughlin, independent experts called by TGS (see footnote (9)).

(5513) TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others.

The Commission contends none the less that the press release was misleading and deceptive because the defendants who prepared the release believed that TGS had a mine. The Commission points to the fact that drilling of K-55-8, the mill test hole, was commenced on April 11, and must have been ordered by the defendants at an earlier time. Both Adelstein and Pennebaker testified that a company does not drill a mill test hole on a "prospect."

(5514) Park, Lacy and Forrester found nothing unusual in this procedure, and Wiles testified that it was usual to begin collecting metallurgical samples as the drilling progresses. With a direct conflict in testimony between the Commission's and defendants' expert witnesses, it cannot be concluded that instructions to drill K-55-8 established that TGS knew that the Kidd 55 segment was no longer a "prospect."

The Commission also points to the *Northern Miner* article which was drafted in Timmins on April 13. Even if it is assumed that Mollison, Holyk and Darke suggested the contents of that article to Ackerley, this would not establish that the April 12 press release was false or deceptive. Using

the Commission's figures, over 30% of the relevant drilling was done between 7:00 p.m. on April 10 and 7:00 a.m. on April 13. K-55-5 was drilled an additional 507 feet; K-55-6 was drilled an additional 375 feet; drilling of K-55-7 was commenced on April 12 on Section 2000 S and was drilled to a length of 146 feet by 7:00 a.m. on April 13. The defendants are to be judged on the facts known to them when the April 12 press release was issued. Mollison and Holyk were not at the site but were in or near New York (5515) while the release was being prepared. There is no evidence that the drilling results after 7:00 p.m. on April 10 were known to the framers of the April 12 press release, so there is no more reason for charging TGS with this knowledge than with knowledge of the statement drafted by Mollison for the Ontario Minister of Mines on April 15, or with knowledge of the information that was available to TGS when it made its announcement on April 16.

Moreover, the circumstances under which the April 12 release was prepared indicate that defendants Fogarty and Mollison were under considerable pressure. If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened. If they had announced the drilling results in terms of number of drill holes, footage drilled and mineralization intersected, they would have encouraged the rumor mill which they were seeking to allay. Perhaps they should have waited until they could have obtained more probative information before issuing a press release, particularly (5516) since developments were breaking so rapidly. However, as above stated, TGS must not be judged by hindsight. In seeking the advice of Mollison, the

ad of TGS's exploration group, in consulting with TGS's blic relations firm, and in clearing the release with one f TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances. While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known.[18]

Accordingly, in issuing the April 12 press release TGS did not violate Section 10(b) or Rule 10b-5.

Conclusion

The foregoing constitutes the Court's findings of fact and conclusions of law (Rule 52(a), Fed. R. Civ. P.).

There appearing no just reason for delay, the Clerk is directed to enter judgment dismissing the complaint against defendants Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Thomas S. Lamont, Francis G. Coates, Claude O. Stephens, John A. Murray, Earl L. Huntington and Harold B. Kline (Rule 58(1), Fed. R. Civ. P.).

(5517) Defendants Richard H. Clayton and David M. Crawford are found to have violated Section 10(b) of the Act and Rule 10b-5. In accordance with the agreement between the parties, the Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.

It is so ordered.

Dated: New York, N. Y.
August 16, 1966.

Dudley B. Bonsal
U. S. D. J.

Filed August 19, 1966

(5518) Footnotes to Opinion in Securities and Exchange Commission v. Texas Gulf Sulphur Company, et al. 65 Civ. 1182

(1) At least 49 private actions are now pending in this court against TGS, defendants named in the Commission's action, and others, arising out of the transactions which are the subject matter of the Commission's action. Some 16 of these are individual actions, 31 are said to be class actions, and one is a derivative action. At least 475 persons are included as plaintiffs. While many of the complaints do not specify the damages claimed, others, in the aggregate, claim compensatory damages in excess of $2,800,000 and punitive damages in excess of $77,000,000.

(2) Certain minerals combine with sulphur to form sulphides. Some sulphides, such as chalcopyrite (copper sulphide) and sphalerite (zinc sulphide), may be commercially mined if found in sufficient quantities; others, such as pyrite and pyrrhotite (iron sulphides), have no commercial value.

(3) The electromagnetic instruments used in the aerial geophysicial surveys indicate only that a conductor of electricity exists. There are many good conductors besides sulphides. For example, graphite and even water are good conductors. On the other hand, zinc sulphides are not conductors.

(4) Prior to April 7 a shortage of water needed for drilling prevented the operation of more than one drill rig. The second rig was put into operation on April 8, and the third and fourth rigs were put into operation on April 10 and 12 respectively.

(5) Seven feet of snow on the ground during this period impeded travel between the Kidd 55 segment and Timmins, 15 miles away, the trip taking as long as four hours.

(6) Rule 10b-5 is general in terms. Other rules under Section 10(b) are more specific. See Rule 10b-6, which applies Section 10(b) to underwriters, issuers, brokers, dealers, etc. Compare also Rule 10b-2 with reference to solicitation of purchases on an exchange to facilitate a distribution of securities.

(5519) (7) In its briefs and at trial the Commission made no distinction between the three sections of Rule 10b-5, rely-

ing on *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir. 1965), where the court noted that as long as a violation of the Rule is alleged, it makes little difference which section of the Rule is invoked. There was no evidence, however, that the defendants employed "any device, scheme, or artifice to defraud" under section (1) or made any representations under section (2). Therefore, only section (3) is applicable to the facts of this case.

(8) Section 206 provides in part that:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client; . . ."

(9) At the trial, the Commission called as expert witnesses Benjamin Adelstein and Edwin M. Pennebaker. Mr. Adelstein has been the Chief Mining Engineer for the Commission since 1941. He was previously employed by Anaconda Copper Company and by the United States Coast and Geodetic Survey and the United States Corps of Engineers. Mr. Pennebaker is a mining geologist from Scottsdale, Arizona with many years of experience, who was appointed Consulting Geologist to the Commission in November 1965.

TGS called as expert witnesses: James D. Forrester, geologist, Dean of the University of Arizona School of Mines and Director of the Arizona Bureau of Mines, Tucson, Arizona; Charles F. Park, Jr., geologist, Professor of Geology at Stanford University, where he was Dean of the School of Earth Sciences from 1950-1965; Cloyd M. Wiles, mining engineer with National Lead Company from 1942 until his retirement in 1963; Graham Walkey, mining engineer and geologist with Kamkotia Mines, which is located approximately 12 miles from the Kidd 55 segment; Willard C. Lacy, geologist, professor at the University of Arizona and head of the University's Department of Mining and Engineering; Donald McLaughlin, geologist, Chairman of the Board and formerly president of Homestake Mining

Company; John B. Boniwell, geophysicist with eight years' experience on the Canadian Shield; Douglas H. Bellemore, security analyst, Professor of Finance at the Graduate School of Business (5520) Administration at New York University; and Alvin W. Pearson, security analyst, president of Lehman Corporation and chairman of its Portfolio Committee.

(10) Adelstein testified that on the basis of work done to 7:00 p.m. on April 9 TGS could have calculated ore reserves of 7.7 million tons with a gross assay value of $204,200,000. Pennebaker testified that TGS could have calculated ore reserves of 5.5 million tons with a gross assay value of $197,200,000. Adelstein defined gross assay value to mean "the sum of the products of the number of units of each metal of commercial value times the prevailing price for each metal . . ." Since gross assay value does not take account of the costs of mining, milling, smelting, sales, overhead, cost of capital, etc., it can be misleading and its use in registration statements is prohibited by the Commission. For example, Wiles estimated that 95.2% of the gross assay value of the ore deposit on the Kidd 55 segment would be expended for the above purposes. Although his figures appear to be conservative and though ore with a much lower gross assay value than that on the Kidd 55 segment is commercially mined, his testimony illustrates why gross assay value is not a good indicator.

(11) Members of the TGS exploration group could not state with certainty that K-55-1 had not been drilled down dip. In a memorandum written on November 14, 1963, defendant Holyk stated that:

> "While there are some indications that the drill hole is drilling across the dip, there are also numerous instances of bedding and minerals stratification to be almost parallel to the core axis. Accordingly, it is impossible to estimate the true width of the sulphide zone until a second drill hole is directed across this intersection from west to east. It may well be that the zone is quite narrow in the event that the drill hole has been directed down dip."

The Commission offered testimony as to banding, mineral stratification within the drill core, to establish that K-55-1 had been drilled across the mineral zone and not down dip. The significance of banding, particularly without more drilling, was strongly disputed by defendants' experts.

(5520) (12) In a symposium held on November 22, 1965, former Commission Chairman Cary stated:

> "Directly related is the question when insiders can trade. Again, I doubt whether we can supply a definitive answer. In general, the answer may be: not prior to the time the news has been absorbed by the market. The President of the New York Stock Exchange has suggested thirty days, beginning one week after the distribution of a comprehensive annual report . . . This line, I think, is strict; it goes beyond law, and is really a policy doctrine that he has enunciated. It goes beyond what a lawyer might advise." (Symposium, "Insider Trading in Stocks, *The Business Lawyer,* Vol. XXI, 1009, 1014-1015 (1966).)

Fleischer has written:

> "As a general principle, an insider might be held to violate rule 10b-5 whenever he trades before the effect of the news in question has been absorbed by the market.
>
> • • • • •
>
> "As a matter of corporate practice, it would be advisable for any insider to forego any trading for, say, an arbitrary twenty-four hour period after important news is released to the public." (Fleischer, "Securities Trading and Corporate Information Practices: The Implications of the *Texas Gulf Sulphur Proceeding,*" 51 *Va. L. Rev.* 1271, 1291 (1965).)

(13) Since no violations of Section 10(b) or Rule 10b-5 have been found as to those defendants who recommended TGS stock to others, it is not necessary to consider whether an insider who violates the Statute or the Rule may be liable for purchases made by his "tippees."

(14) The stock options accepted by these defendants were as follows:

Stephens	for	12,800	shares
Fogarty	"	7,300	"
Kline	"	4,300	"
Mollison	"	4,300	"
Holyk	"	2,000	"

Stock options were granted to 21 other officers and employees at the same time, and the total number of shares covered by stock options granted on February 20, 1964 was 89,950.

(5521) (15) The Plan provided that the options would run for ten years from the date of issue, subject to automatic termination in the event of the death or termination of employment of the recipient. At its meeting, the Committee recommended that the plan be amended to reduce the option period from ten years to five years, to become effective on passage of pending Congressional legislation to that effect; that such amendment apply to the options granted on February 20, 1964; and further, that the options issued on February 20, 1964 could not be exercised while any previous qualified or restricted option was held by the optionee. The options provided that the optionees could exercise up to 40% at any time after 18 months, 70% at any time after three years and 100% at any time after four years.

(16) The Board was not informed until its meeting on April 16, 1964, when the Directors were given copies of the press release which was issued following the meeting.

(17) After the Commission instituted this action, the Board of Directors, on July 15, 1965, ratified the issuance of the stock options to Kline, Mollison and Holyk. Stephens and Fogarty surrendered to TGS the options which they received, and these options have been cancelled.

(18) That the drilling results to 7:00 p.m. on April 9 have been held to be material information does not lead to the conclusion that the Kidd 55 segment was either a mine or a prospect twenty-four hours later. It means only that insiders could act on this material information to their own advantage prior to its disclosure to the public.

Appendix A — Judgment of the District Court (Entered August 22, 1966)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

The defendant Thomas P. O'Neill having been served with a summons and complaint, and said defendant having failed to answer or appear herein, and the plaintiff having moved for a default judgment in a separate proceeding, and all the remaining parties having waived a jury and having agreed that trial should first be had on the issue of whether defendants or any of them had violated Section 10(b) and Rule 10b-5 reserving for a later hearing the issue of the remedy to be applied in the event such violations are found, and the said issue having been brought on regularly for trial before the Honorable Dudley B. Bonsal, United States District Judge, on May 9, 10, 11, 12, 13, 23, 24, 25, 26, 27, 31 and June 1, 2, 3, 6, 7, 8 and 21, 1966, and the Court having reserved decision at the conclusion of the evidence, and the Court thereafter having handed down its opinion decision, dated August 16, 1966 and filed on August 19, 1966 constituting the Court's findings of fact and conclusions of law dismissing the complaint as to all defendants except Richard H. Clayton and David M. Crawford, and the Court having found that the defendants Richard H. Clayton and David M. Crawford had violated Section 10(b) of the Act and Rule 10b-5, and the Court in its opinion decision having stated that there was no just reason for delay of entry of this Judgment, it is

Appendix A — Judgment of the District Court

ORDERED, ADJUDGED AND DECREED: That the defendants, Texas Gulf Sulphur Company, a Texas corporation, Charles F. Fogarty, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Thomas S. Lamont, Francis G. Coates, Claude O. Stephens, John A. Murray, Earl L. Huntington and Harold B. Kline have judgment against the plaintiff Securities and Exchange Commission dismissing the complaint, and it is further,

ORDERED, ADJUDGED AND DECREED: That the defendants Richard H. Clayton and David M. Crawford have violated Section 10(b) of the Act and Rule 10b-5, and pursuant to agreement between the parties, the Securities and Exchange Commission may notice a hearing to determine the remedy to be accorded with respect to these two defendants.

Dated: New York, N.Y.
August 22, 1966

John J. Olear, Jr.
Clerk

Appendix A — Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 296—September Term, 1966.

(Argued March 20, 1967
Submitted to the *in banc* Court May 2, 1968
Decided August 13, 1968.)

Docket No. 30882

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellant,

—v.—

TEXAS GULF SULPHUR CO., a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, WALTER HOLYK, KENNETH H. DARKE, FRANCIS G. COATES, CLAUDE O. STEPHENS, JOHN A. MURRAY, EARL L. HUNTINGTON, and HAROLD B. KLINE,

Defendants-Appellees.

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

—v.—

DAVID M. CRAWFORD and RICHARD H. CLAYTON,

Defendants-Appellants.

Before:

LUMBARD, *Chief Judge*,
WATERMAN, MOORE, FRIENDLY, SMITH, KAUFMAN, HAYS,
ANDERSON and FEINBERG, *Circuit Judges*.

In the United States District Court for the Southern District of New York the Securities and Exchange Commission commenced its action pursuant to 15 U. S. C. §§78u, 78aa, against Texas Gulf Sulphur Company and thirteen individuals alleging violations by the fourteen defendants of the provisions of Section 10b of the Securities Exchange Act of 1934, 15 U. S. C. §78j(b), and its Rule 10b-5 (17 C. F. R. 240.10b-5) promulgated pursuant to the authority granted to it in Section 10b.

The court below, Bonsal, *J.*, found that two of the individual defendants, Clayton and Crawford, had violated Section 10b and Rule 10b-5, but otherwise the Commission's complaint was ordered dismissed, 258 F. Supp. 262 (1966).

Appeals were taken by the Commission and by Clayton and Crawford. Eleven of the thirteen original individual defendants, and the corporation, are parties in the proceedings before us.

The appeals were argued before a division of the court consisting of Judges Waterman, Moore, and Hays. When the opinions prepared by them were distributed to the other judges of the court it was ordered on May 2, 1968 that the case should, without further argument, be considered *in banc* upon the record and briefs the parties had filed and upon the opinions that had been prepared and distributed by the panel judges. After *in banc* consideration the opinions appearing hereafter were prepared. The results reached in Judge Waterman's opinion for the court are

concurred in unanimously as to appellee Coates, and appellants Clayton and Crawford; as to the remaining contested issues that opinion represents results concurred in either generally or in separate statements by a majority of the judges.

The dispositions below as to appellants Clayton and Crawford are affirmed. As to one of the appellees, Murray, the disposition below is affirmed. As to the remaining individual appellees and the corporation, the order dismissing the complaint is reversed and the cause remanded for further proceedings below consistent with the opinion of the court.

PHILIP A. LOOMIS, JR., Gen. Counsel; DAVID FERBER, Solicitor; ROGER S. FOSTER, Spec. Counsel, Ofc. of Policy Research, SEC; FRANK E. KENNAMER, JR., Asst. Gen. Counsel; DONALD M. FEUERSTEIN, Atty., SEC, *for Securities and Exchange Commission.*

ORISON S. MARDEN, White & Case, WILLIAM D. CONWELL, EDWARD C. SCHMULTS, P. R. KONRAD KNAKE, THOMAS MCGANNEY, PETER G. EIKENBERRY, New York City, *for Texas Gulf Sulphur, Fogarty, Mollison, Holyk, Darke, Stephens, Murray, Huntington and Kline, Crawford and Clayton.*

ALBERT R. CONNELLY, DONALD I. STRAUBER, Cravath, Swaine & Moore, New York City, *for Coates.*

WATERMAN, *Circuit Judge*:

This action was commenced in the United States District Court for the Southern District of New York by the

Securities and Exchange Commission (the SEC) pursuant to Sec. 21(e) of the Securities Exchange Act of 1934 (the Act), 15 U. S. C. §78u(e), against Texas Gulf Sulphur Company (TGS) and several of its officers, directors and employees, to enjoin certain conduct by TGS and the individual defendants said to violate Section 10(b) of the Act, 15 U. S. C. Section 78j(b), and Rule 10b-5 (17 CFR 240.10b-5) (the Rule), promulgated thereunder, and to compel the rescission by the individual defendants of securities transactions assertedly conducted contrary to law.[1] The complaint alleged (1) that defendants Fogarty, Mollison, Darke, Murray, Huntington, O'Neill, Clayton, Crawford, and Coates had either personally or through agents purchased TGS stock or calls thereon from November 12, 1963 through April 16, 1964 on the basis of material inside information concerning the results of TGS drilling in Timmins, Ontario, while such information remained undisclosed to the investing public generally or to the particular sellers[2]; (2) that defendants Darke and Coates had di-

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1 Pursuant to a stipulation by all parties, the question of the appropriate remedies to be applied was deferred pending a final determination whether the defendants or any of them had violated Section 10(b) and Rule 10b-5 and therefore that question is not now before us.

2 The purchases by the parties during this period were:

Purchase		*Shares*		*Calls*	
Date	*Purchaser*	*Number*	*Price*	*Number*	*Price*
Hole K-55-1 Completed November 12, 1963					
1963					
Nov. 12	Fogarty	300	17¾-18		
15	Clayton	200	17¾		
15	Fogarty	700	17⅝-17⅞		
15	Mollison	100	17⅞		
19	Fogarty	500	18⅛		
26	Fogarty	200	17¾		
29	Holyk (Mrs.)	50	18		

Chemical Assays of Drill Core of K-55-1 Received December 9-13, 1963

(*footnote continued on next page*)

vulged such information to others for use in purchasing TGS stock or calls[3] or recommended its purchase while the

Purchase			*Shares*		*Calls*	
Date		*Purchaser*	*Number*	*Price*	*Number*	*Price*
1963						
Dec.	10	Holyk (Mrs.)	100	20⅜		
	12	Holyk (or wife)			200	21
	13	Mollison	100	21⅛		
	30	Fogarty	200	22		
	31	Fogarty	100	23¼		
1964						
Jan.	6	Holyk (or wife)			100	23⅝
	8	Murray			400	23¼
	24	Holyk (or wife)			200	22¼-22⅜
Feb.	10	Fogarty	300	22⅛-22¼		
	20	Darke	300	24⅛		
	24	Clayton	400	23⅞		
	24	Holyk (or wife)			200	24⅛
	26	Holyk (or wife)			200	23⅜
	26	Huntington	50	23¼		
	27	Darke (Moran as nominee)			1000	22⅝-22¾
Mar.	2	Holyk (Mrs.)	200	22⅜		
	3	Clayton	100	22¼		
	16	Huntington			100	22⅜
	16	Holyk (or wife)			300	23¼
	17	Holyk (Mrs.)	100	23⅞		
	23	Darke			1000	24¾
	26	Clayton	200	25		
Land Acquisition Completed March 27, 1964						
Mar.	30	Darke			1000	25½
	30	Holyk (Mrs.)	100	25⅞		
Core Drilling of Kidd Segment Resumed March 31, 1964						
April	1	Clayton	60	26½		
	1	Fogarty	400	26½		
	2	Clayton	100	26⅞		
	6	Fogarty	400	28⅛-28⅞		
	8	Mollison (Mrs.)	100	28⅛		
First Press Release Issued April 12, 1964						
April	15	Clayton	200	29⅜		
	16	Crawford (and wife)	600	30⅛-30¼		
Second Press Release Issued 10:00-10:10 or 10:15 A.M., April 16, 1964						
April	16	(app. 10:20 A.M.) Coates (for family trusts)	2000	31 -31⅝		

3 A "call" is a negotiable option contract by which the bearer has the right to buy from the writer of the contract a certain number of shares of a particular stock at a fixed price on or before a certain agreed-upon date.

information was undisclosed to the public or to the sellers;[4] that defendants Stephens, Fogarty, Mollison, Holyk, and

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4 The purchases made by "tippees" during this period were:

Purchase Date	Purchaser	Shares Number	Shares Price	Calls Number	Calls Price
Chemicals Assays of K-55-1 Received Dec. 9-13, 1963					
1963					
Dec. 30	Caskey (Darke)			300	22¼
1964					
Jan. 16	Westreich (Darke)	2000	21¼-21¾		
Feb. 17	Atkinson (Darke)	50	23¼	200	23⅛
17	Westreich (Darke)	50	23¼	1000	23¼-23⅜
24	Miller (Darke)			200	23¾
25	Miller (Darke)			300	23⅜-23½
Mar. 3	E. W. Darke (Darke)			500	22½-22⅝
17	E. W. Darke (Darke)			200	23⅜
Land Acquisition Completed Mar. 27, 1964					
1964					
Mar. 30	Atkinson (Darke)				
	Caskey (Darke)	100	25⅞	400	25¾-25⅞
	E. W. Darke (Darke)				
	Miller (Darke)			1000	25¾-25⅞
	Westreich (Darke)	500	25¾	200	25½
30-31	Klotz (Darke)			2000	25½-26⅛

Second Press Release Issued April 16, 1964 (Reported over Dow Jones tape at 10:54 A.M.)

April 16 (from 10:31 A.M.)

Haemisegger (Coates) 1500 31¼-35

In this connection, we point out that, though several of the Holyk purchases of shares and calls made between November 29, 1963 and March 30, 1964 were in the name of Mrs. Holyk or were in the names of both spouses, we have treated these purchases as if made in the name of defendant Holyk alone.

Defendant Mollison purchased 100 shares on November 15 in his name only and on April 8 100 shares were purchased in the name of Mrs. Mollison. We have made no distinction between those purchases.

Defendant Crawford ordered 300 shares about midnight on April 15 and 300 more shares the following morning, to be purchased for himself, and his wife, and these purchases are treated as having been made by the defendant Crawford.

In these particulars we have followed the lead of the court below. See the table at 258 F. Supp. 273-275 and the special references to the Holyk purchases at 273, and the Crawford purchases at 287. It would be unrealistic to include any of these purchases as having been made by other than the defendants, and unrealistic to include them as having been made by members of the general public receiving "tips" from insiders.

Kline had accepted options to purchase TGS stock on Feb. 20, 1964 without disclosing the material information as to the drilling progress to either the Stock Option Committee or the TGS Board of Directors; and (4) that TGS issued a deceptive press release on April 12, 1964. The case was tried at length before Judge Bonsal of the Southern District of New York, sitting without a jury. Judge Bonsal in a detailed opinion[5] decided, *inter alia*, that the insider activity prior to April 9, 1964 was not illegal because the drilling results were not "material" until then; that Clayton and Crawford had traded in violation of law because they traded after that date; that Coates had committed no violation as he did not trade before disclosure was made; and that the issuance of the press release was not unlawful because it was not issued for the purpose of benefiting the corporation, there was no evidence that any insider used the release to his personal advantage and it was not "misleading, or deceptive on the basis of the facts then known," 258 F. Supp. 262, at 292-296 (SDNY 1966). Defendants Clayton and Crawford appeal from that part of the decision below which held that they had violated Sec. 10(b) and Rule 10b-5 and the SEC appeals from the remainder of the decision which dismissed the complaint against defendants TGS, Fogarty, Mollison, Holyk, Darke, Stephens, Kline, Murray, and Coates.[6]

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5 258 F. Supp. 262 (SDNY 1966).

6 Defendant O'Neill did not appear to answer the charge against him; the SEC motion to enter a default judgment against him was denied without prejudice to its renewal upon completion of this appeal.

Shortly after the appeal was argued defendant Lamont passed away, and by agreement of the parties an order was entered discontinuing his appeal and directing that the judgment below dismissing the action against him be severed from the judgment as to the other defendants.

The SEC does not contest the alternative holding below that Holyk and Mollison, not being members of TGS's top management, had no duty of disclosure prior to acceptance of stock options.

For reasons which appear below, we decide the various issues presented as follows:

(1) As to Clayton and Crawford, as purchasers of stock on April 15 and 16, 1964, we affirm the finding that they violated 15 U. S. C. §78j(b) and Rule 10b-5 and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(2) As to Murray, we affirm the dismissal of the complaint.

(3) As to Mollison and Holyk, as recipients of certain stock options, we affirm the dismissal of the complaint.

(4) As to Stephens and Fogarty, as recipients of stock options, we reverse the dismissal of the complaint and remand for a further determination as to whether an injunction, in the exercise of the trial court's discretion, should issue.

(5) As to Kline, as a recipient of a stock option, we reverse the dismissal of the complaint and remand with directions to issue an order rescinding the option and for a determination of any other appropriate remedy in connection therewith.

(6) As to Fogarty, Mollison, Holyk, Darke, and Huntington, as purchasers of stock or calls thereon between November 12, 1963, and April 9, 1964, we reverse the dismissal of the complaint and find that they violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement of all the parties, for a determination of the appropriate remedy.

(7) As to Clayton, although the district judge did not specify that the complaint be dismissed with respect to

his purchases of TGS stock before April 9, 1964, such a dismissal is implicit in his treatment of the individual appellees who acted similarly. Consequently, although Clayton is named only as an appellant our decision with respect to the materiality of K-55-1 renders it necessary to treat him also as an appellee. Thus, as to him, as one who purchased stock between November 12, 1963 and April 9, 1964, we reverse the implicit dismissal of the complaint, find that he violated §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(8) As to Drake, as one who passed on information to tippees, we reverse the dismissal of the complaint and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(9) As to Coates, as one who on April 16th purchased stock and gave information on which his son-in-law broker and the broker's customers purchased shares, we reverse the dismissal of the complaint, find that he violated 15 U. S. C. §78j(b) and Rule 10b-5, and remand, pursuant to the agreement by all the parties, for a determination of the appropriate remedy.

(10) As to Texas Gulf Sulphur, we reverse the dismissal of the complaint and remand for a further determination by the district judge in the light of the approach taken in this opinion.

The occurrences out of which this litigation arose are not set forth hereafter in as detailed a manner as they are set out in the published opinion of the court below, but are stated sufficiently, we believe, for the exposition of the issues raised by the several appeals to us.

The Factual Setting

This action derives from the exploratory activities of TGS begun in 1957 on the Canadian Shield in eastern Canada. In March of 1959, aerial geophysical surveys were conducted over more than 15,000 square miles of this area by a group led by defendant Mollison, a mining engineer and a Vice President of TGS. The group included defendant Holyk, TGS's chief geologist, defendant Clayton, an electrical engineer and geophysicist, and defendant Darke, a geologist. These operations resulted in the detection of numerous anomalies, i.e., extraordinary variations in the conductivity of rocks, one of which was on the Kidd 55 segment of land located near Timmins, Ontario.

On October 29 and 30, 1963, Clayton conducted a ground geophysical survey on the northeast portion of the Kidd 55 segment which confirmed the presence of an anomaly and indicated the necessity of diamond core drilling for further evaluation. Drilling of the initial hole, K-55-1, at the strongest part of the anomaly was commenced on November 8 and terminated on November 12 at a depth of 655 feet. Visual estimates by Holyk of the core of K-55-1 indicated an average copper content of 1.15% and an average zinc content of 8.64% over a length of 599 feet. This visual estimate convinced TGS that it was desirable to acquire the remainder of the Kidd 55 segment, and in order to facilitate this acquisition TGS President Stephens instructed the exploration group to keep the results of K-55-1 confidential and undisclosed even as to other officers, directors, and employees of TGS. The hole was concealed and a barren core was intentionally drilled off the anomaly. Meanwhile, the core of K-55-1 had been shipped to Utah for chemical assay which, when received in early December, revealed an average mineral content of 1.18% copper, 8.26%

zinc, and 3.94% ounces of silver per ton over a length of 602 feet. These results were so remarkable that neither Clayton, an experienced geophysicist, nor four other TGS expert witnesses, had ever seen or heard of a comparable initial exploratory drill hole in a base metal deposit. So, the trial court concluded, "There is no doubt that the drill core of K-55-1 was unusually good and that it excited the interest and speculation of those who knew about it." *Id.* at 282. By March 27, 1964, TGS decided that the land acquisition program had advanced to such a point that the company might well resume drilling, and drilling was resumed on March 31.

During this period, from November 12, 1963 when K-55-1 was completed, to March 31, 1964 when drilling was resumed, certain of the individual defendants listed in fn. 2, *supra,* and persons listed in fn. 4, *supra,* said to have received "tips" from them, purchased TGS stock or calls thereon. Prior to these transactions these persons had owned 1135 shares of TGS stock and possessed no calls; thereafter they owned a total of 8235 shares and possessed 12,300 calls.

On February 20, 1964, also during this period, TGS issued stock options to 26 of its officers and employees whose salaries exceeded a specified amount, five of whom were the individual defendants Stephens, Fogarty, Mollison, Holyk, and Kline. Of these, only Kline was unaware of the detailed results of K-55-1, but he, too, knew that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins. At this time, neither the TGS Stock Option Committee nor its Board of Directors had been informed of the results of K-55-1, presumably because of the pending land acquisition program which required confidentiality. All of the foregoing defendants accepted the options granted them.

When drilling was resumed on March 31, hole K-55-3 was commenced 510 feet west of K-55-1 and was drilled easterly at a 45° angle so as to cross K-55-1 in a vertical plane. Daily progress reports of the drilling of this hole K-55-3 and of all subsequently drilled holes were sent to defendants Stephens and Fogarty (President and Executive Vice President of TGS) by Holyk and Mollison. Visual estimates of K-55-3 revealed an average mineral content of 1.12% copper and 7.93% zinc over 641 of the hole's 876-foot length. On April 7, drilling of a third hole, K-55-4, 200 feet south of and parallel to K-55-1 and westerly at a 45° angle, was commenced and mineralization was encountered over 366 of its 579-foot length. Visual estimates indicated an average content of 1.14% copper and 8.24% zinc. Like K-55-1, both K-55-3 and K-55-4 established substantial copper mineralization on the eastern edge of the anomaly. On the basis of these findings relative to the foregoing drilling results, the trial court concluded that the vertical plane created by the intersection of K-55-1 and K-55-3, which measured at least 350 feet wide by 500 feet deep extended southward 200 feet to its intersection with K-55-4, and that "There was real evidence that a body of commercially mineable ore might exist." *Id.* at 281-82.

On April 8 TGS began with a second drill rig to drill another hole, K-55-6, 300 feet easterly of K-55-1. This hole was drilled westerly at an angle of 60° and was intended to explore mineralization beneath K-55-1. While no visual estimates of its core were immediately available, it was readily apparent by the evening of April 10 that substantial copper mineralization had been encountered over the last 127 feet of the hole's 569-foot length. On April 10, a third drill rig commenced drilling yet another hole, K-55-5, 200 feet north of K-55-1, parallel to the prior

holes, and slanted westerly at a 45° angle. By the evening of April 10 in this hole, too, substantial copper mineralization had been encountered over the last 42 feet of its 97-foot length.

Meanwhile, rumors that a major ore strike was in the making had been circulating throughout Canada. On the morning of Saturday, April 11, Stephens at his home in Greenwich, Conn. read in the New York Herald Tribune and in the New York Times unauthorized reports of the TGS drilling which seemed to infer a rich strike from the fact that the drill cores had been flown to the United States for chemical assay. Stephens immediately contacted Fogarty at his home in Rye, N. Y., who in turn telephoned and later that day visited Mollison at Mollison's home in Greenwich to obtain a current report and evaluation of the drilling progress.[7] The following morning, Sunday, Fogarty again telephoned Mollison, inquiring whether Mollison had any further information and told him to return to Timmins with Holyk, the TGS Chief Geologist, as soon as possible "to move things along." With the aid of one Carroll, a public relations consultant, Fogarty drafted a press release designed to quell the rumors, which release, after having been channeled through Stephens and Huntington, a TGS attorney, was issued at 3:00 P.M. on Sunday, April 12, and which appeared in the morning newspapers of general circulation on Monday, April 13. It read in pertinent part as follows:

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7 Mollison had returned to the United States for the weekend. Friday morning, April 10, he had been on the Kidd tract "and had been advised by defendant Holyk as to the drilling results to 7:00 p.m. on April 10. At that time drill holes K-55-1, K-55-3 and K-55-4 had been completed; drilling of K-55-5 had started on Section 2200 S and had been drilled to 97 feet, encountering mineralization on the last 42 feet; and drilling of K-55-6 had been started on Section 2400 S and had been drilled to 569 feet, encountering mineralization over the last 127 feet." *Id.* at 294.

NEW YORK, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

"During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

"The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

"Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite without value; a few have resulted in discoveries of small or marginal sulphide ore bodies.

"Recent drilling on one property near Timmins has led to preliminary indications that more drilling would

be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

* * * * *

The release purported to give the Timmins drilling results as of the release date, April 12. From Mollison Fogarty had been told of the developments through 7:00 P.M. on April 10, and of the remarkable discoveries made up to that time, detailed *supra*, which discoveries, according to the calculations of the experts who testified for the SEC at the hearing, demonstrated that TGS had already discovered 6.2 to 8.3 million tons of proven ore having gross assay values from $26 to $29 per ton. TGS experts, on the other hand, denied at the hearing that proven or probable ore could have been calculated on April 11 or 12 because there was then no assurance of continuity in the mineralized zone.

The evidence as to the effect of this release on the investing public was equivocal and less than abundant. On April 13 the New York Herald Tribune in an article head-noted "Copper Rumor Deflated" quoted from the TGS release of April 12 and backtracked from its original April 11 report

of a major strike but nevertheless inferred from the TGS release that "recent mineral exploratory activity near Timmins, Ontario, has provided preliminary favorable results, sufficient at least to require a step-up in drilling operations." Some witnesses who testified at the hearing stated that they found the release encouraging. On the other hand, a Canadian mining security specialist, Roche, stated that "earlier in the week [before April 16] we had a Dow Jones saying that they [TGS] didn't have anything basically" and a TGS stock specialist for the Midwest Stock Exchange became concerned about his long position in the stock after reading the release. The trial court stated only that "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." *Id.* at 296.

Meanwhile, drilling operations continued. By the morning of April 13, in K-55-5, the fifth drill hole, substantial copper mineralization had been encountered to the 580 foot mark, and the hole was subsequently drilled to a length of 757 feet without further results. Visual estimates revealed an average content of 0.82% copper and 4.2% zinc over a 525-foot section. Also by 7:00 A.M. on April 13, K-55-6 had found mineralization to the 946-foot mark. On April 12 a fourth drill rig began to drill K-55-7, which was drilled westerly at a 45° angle, at the eastern edge of the anomaly. The next morning the 137 foot mark had been reached, fifty feet of which showed mineralization. By 7:00 P.M. on April 15, the hole had been completed to a length of 707 feet but had only encountered additional mineralization during a 26-foot length between the 425 and 451-foot marks. A mill test hole, K-55-8, had been drilled and was complete by the evening of April 13 but its mineralization had not been reported upon prior to April

16. K-55-10 was drilled westerly at a 45° angle commencing April 14 and had encountered mineralization over 231 of its 249-foot length by the evening of April 15. It, too, was drilled at the anomaly's eastern edge.

While drilling activity ensued to completion, TGS officials were taking steps toward ultimate disclosure of the discovery. On April 13, a previously-invited reporter for The Northern Miner, a Canadian mining industry journal, visited the drillsite, interviewed Mollison, Holyk and Darke, and prepared an article which confirmed a 10 million ton ore strike. This report, after having been submitted to Mollison and returned to the reporter unamended on April 15, was published in the April 16 issue. A statement relative to the extent of the discovery, in substantial part drafted by Mollison, was given to the Ontario Minister of Mines for release to the Canadian media. Mollison and Holyk expected it to be released over the airways at 11 P.M. on April 15th, but, for undisclosed reasons, it was not released until 9:40 A.M. on the 16th. An official detailed statement, announcing a strike of at least 25 million tons of ore, based on the drilling data set forth above, was read to representatives of American financial media from 10:00 A.M. to 10:10 or 10:15 A.M. on April 16, and appeared over Merrill Lynch's private wire at 10:29 A.M. and, somewhat later than expected, over the Dow Jones ticker tape at 10:54 A.M.

Between the time the first press release was issued on April 12 and the dissemination of the TGS official announcement on the morning of April 16, the only defendants before us on appeal who engaged in market activity were Clayton and Crawford and TGS director Coates. Clayton ordered 200 shares of TGS stock through his Canadian

broker on April 15 and the order was executed that day over the Midwest Stock Exchange. Crawford ordered 300 shares at midnight on the 15th and another 300 shares at 8:30 A.M. the next day, and these orders were executed over the Midwest Exchange in Chicago at its opening on April 16. Coates left the TGS press conference and called his broker son-in-law Haemisegger shortly before 10:20 A.M. on the 16th and ordered 2,000 shares of TGS for family trust accounts of which Coates was a trustee but not a beneficiary; Haemisegger executed this order over the New York and Midwest Exchanges, and he and his customers purchased 1500 additional shares.

During the period of drilling in Timmins, the market price of TGS stock fluctuated but steadily gained overall. On Friday, November 8, when the drilling began, the stock closed at 17⅜; on Friday, November 15, after K-55-1 had been completed, it closed at 18. After a slight decline to 16⅜ by Friday, November 22, the price rose to 20⅞ by December 13, when the chemical assay results of K-55-1 were received, and closed at a high of 24⅛ on February 21, the day after the stock options had been issued. It had reached a price of 26 by March 31, after the land acquisition program had been completed and drilling had been resumed, and continued to ascend to 30⅛ by the close of trading on April 10, at which time the drilling progress up to then was evaluated for the April 12th press release. On April 13, the day on which the April 12 release was disseminated, TGS opened at 30⅛, rose immediately to a high of 32 and gradually tapered off to close at 30⅞. It closed at 30¼ the next day, and at 29⅜ on April 15. On April 16, the day of the official announcement of the Timmins discovery, the price climbed to a high of 37 and closed at 36⅜. By May 15, TGS stock was selling at 58¼.

I. The Individual Defendants

A. *Introductory*

Rule 10b-5, 17 CFR 240.10b-5, on which this action is predicated, provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme, or artifice to defraud,
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

Rule 10b-5 was promulgated pursuant to the grant of authority given the SEC by Congress in Section 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. 78j(b).[8]

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8 15 U. S. C. §78j reads in pertinent part as follows:

> §78j. Manipulative and deceptive devices
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * *
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device

By that Act Congress purposed to prevent inequitable and unfair practices and to insure fairness in securities transactions generally, whether conducted face-to-face, over the counter, or on exchanges, see 3 Loss, Securities Regulation 1455-56 (2d ed. 1961). The Act and the Rule apply to the transactions here, all of which were consummated on exchanges. See *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 461-62 (2 Cir.), *cert. denied*, 382 U. S. 811 (1965); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239, 243 (SDNY 1962). Whether predicated on traditional fiduciary concepts, see, e.g., *Hotchkiss* v. *Fisher*, 16 P. 2d 531 (Kan. 1932), or on the "special facts" doctrine, see, e.g., *Strong* v. *Repide*, 213 U. S. 419 (1909), the Rule is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information, see Cary, Insider Trading in Stocks, 21 Bus. Law. 1009, 1010 (1966), Fleischer, Securities Trading and Corporation Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1278-80 (1965). The essence of the Rule is that anyone who, trading for his own account in the securities of a corporation has "access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone" may not take "advantage of such information knowing it is unavailable to those with whom he is dealing," i.e., the investing public. *Matter of Cady, Roberts & Co.*, 40 SEC 907, 912 (1961). Insiders, as directors or management officers are, of course, by this Rule, precluded from so unfairly dealing, but the Rule is also applicable to one

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or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

possessing the information who may not be strictly termed an "insider" within the meaning of Sec. 16(b) of the Act. *Cady, Roberts, supra.* Thus, anyone in possession of material inside information must either disclose it to the investing public, or, if he is disabled from disclosing it in order to protect a corporate confidence, or he chooses not to do so, must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed. So, it is here no justification for insider activity that disclosure was forbidden by the legitimate corporate objective of acquiring options to purchase the land surrounding the exploration site; if the information was, as the SEC contends, material,[9] its possessors should have kept out of the market until disclosure was accomplished. *Cady, Roberts, supra* at 911.

B. *Material Inside Information*

An insider is not, of course, always foreclosed from investing in his own company merely because he may be more familiar with company operations than are outside investors. An insider's duty to disclose information or his duty to abstain from dealing in his company's securities arises only in "those situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if [the extraordinary situation is] disclosed." Fleischer, Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding, 51 Va. L. Rev. 1271, 1289.

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9 Congress intended by the Exchange Act to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office. See Sections 2 and 16 of the Act; H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 13 (1934); S. Rep. No. 792, 73rd Cong., 2d Sess. 9 (1934); S. E. C., Tenth Annual Report 50 (1944). See *Cady, Roberts, supra* at 912.

Nor is an insider obligated to confer upon outside investors the benefit of his superior financial or other expert analysis by disclosing his educated guesses or predictions. 3 Loss, *op. cit. supra* at 1463. The only regulatory objective is that access to material information be enjoyed equally, but this objective requires nothing more than the disclosure of basic facts so that outsiders may draw upon their own evaluative expertise in reaching their own investment decisions with knowledge equal to that of the insiders.

This is not to suggest, however, as did the trial court, that "the test of materiality must necessarily be a conservative one, particularly since many actions under Section 10(b) are brought on the basis of hindsight," 258 F. Supp. 262 at 280, in the sense that the materiality of facts is to be assessed solely by measuring the effect the knowledge of the facts would have upon prudent or conservative investors. As we stated in *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462, "The basic test of materiality . . . is whether a *reasonable* man would attach importance . . . in determining his choice of action in the transaction in question. Restatement, Torts §538(2)(a); accord Prosser, Torts 554-55; I Harper & James, Torts 565-66." (Emphasis supplied.) This, of course, encompasses any fact ". . . which in reasonable and objective contemplation *might* affect the value of the corporation's stock or securities. . . ." *List* v. *Fashion Park, Inc., supra* at 462, quoting from *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (7 Cir. 1963). (Emphasis supplied.) Such a fact is a material fact and must be effectively disclosed to the investing public prior to the commencement of insider trading in the corporation's securities. The speculators and chartists of Wall and Bay Streets are also "reasonable" investors entitled to the same

legal protection afforded conservative traders.[10] Thus, material facts include not only information disclosing the earnings and distributions of a company but also those facts which affect the probable future of the company and those which may affect the desire of investors to buy, sell, or hold the company's securities.

In each case, then, whether facts are material within Rule 10b-5 when the facts relate to a particular event and are undisclosed by those persons who are knowledgeable thereof will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity. Here, notwithstanding the trial court's conclusion that the results of the first drill core, K-55-1, were "too 'remote' . . . to have had any significant impact on the market, i.e., to be deemed material,"[11] 258 F. Supp. at 283, knowledge of the possibility, which surely was

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10 The House of Representatives committee that reported out the bill which eventually became the Act did so with the observation that "no investor, *no speculator*, can safely buy and sell securities upon exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." H. R. Rep. No. 1383, 73d Cong., 2d Sess. (1934), p. 11. (Emphasis supplied.)

Dr. Bellemore, the Texas Gulf defendants' expert witness, has written: "The intelligent speculator assumes that facts are available for a thorough analysis. The speculator then examines the facts to discover and evaluate the risks that are present. He then balances these risks against the apparent opportunities for capital gains and makes his decision accordingly. He is, to the best of his ability, taking calculated risks." Bellemore, Investments: Principles, Practices and Analysis 4 (2d ed. 1962).

11 We are not, of course, bound by the trial court's determination as to materiality unless we find it "clearly erroneous" for that standard of appellate review is applicable only to issues of basic fact and not to issues of ultimate fact. See *Baranow* v. *Gibraltar Factors Corp.*, 366 F. 2d 584, 587 (2 Cir. 1966); *Mamiye Bros.* v. *Barber S.S. Lines, Inc.*, 360 F. 2d 774, 776-78 (2 Cir.), cert. denied, 385 U. S. 835 (1966); see also *SEC* v. *R. A. Holman & Co.*, 366 F. 2d 456, 457-58 (2 Cir. 1966) (by implication).

more than marginal, of the existence of a mine of the ast magnitude indicated by the remarkably rich drill cor o- cated rather close to the surface (suggesting minea v by the less expensive open-pit method) within the con of a large anomaly (suggesting an extensive region mineralization) might well have affected the price of TG. stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold. After all, this first drill core was "unusually good and . . . excited the interest and speculation of those who knew about it." 258 F. Supp. at 282.

Our disagreement with the district judge on this issue does not, then, go to his findings of basic fact, as to which the "clearly erroneous" rule would apply, but to his understanding of the legal standard applicable to them. See *In re Hygrade Envelope Corp.*, 366 F. 2d 584, 587-89 (2 Cir. 1966), and cases cited in footnote 11 *supra*. Our survey of the facts found below conclusively establishes that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock.[12] On April 16, *The Northern Miner*, a trade publication in wide circulation among mining stock specialists, called K-55-1, the discovery hole, "one of the most impressive drill holes completed in

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12 We do not suggest that material facts must be disclosed immediately; the timing of disclosure is a matter for the business judgment of the corporate officers entrusted with the management of the corporation within the affirmative disclosure requirements promulgated by the exchanges and by the SEC. Here, a valuable corporate purpose was served by delaying the publication of the K-55-1 discovery. We do intend to convey, however, that where a corporate purpose is thus served by withholding the news of a material fact, those persons who are thus quite properly true to their corporate trust must not during the period of non-disclosure deal personally in the corporation's securities or give to outsiders confidential information not generally available to all the corporations' stockholders and to the public at large.

modern times."[13] Roche, a Canadian broker whose firm specialized in mining securities, characterized the importance to investors of the results of K-55-1. He stated that the completion of "the first drill hole" with "a 600 foot drill core is very very significant . . . anything over 200 feet is considered very significant and 600 feet is just beyond your wildest imagination." He added, however, that it "is a natural thing to buy more stock once they give you the first drill hole." Additional testimony revealed that the prices of stocks of other companies, albeit less

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13 The April 16th article in The Northern Miner resulted from the reporter's April 13th visit to the drill site where he interviewed defendants Mollison, Holyk and Darke and looked at records of the drilling to that time. The text of the article was approved by Mollison in Timmins on April 15th. The first five paragraphs read as follows:

Should Make Substantial Open Pit Operation

TEXAS GULF SULPHUR COMES UP WITH A "MAJOR"

See Big Tonnages Of Base Metals, Plus Silver

Texas Gulf Sulphur has chalked up a brilliant exploration success in its field program north of the Porcupine area. Following a visit to the discovery property, The Northern Miner can say that a major new zinc-copper-silver mine is definitely in the making, one that has all the earmarks of shaping into a substantial open pit operation.

Only a relative handful of holes has been completed since the discovery hole but on the basis of seven tests either completed or drilling it can be stated that a strike length of 600 ft. minimum has been established, showing an ore width of roughly 300 ft. which has been traced so far to a maximum vertical depth of about 800 ft.

So recent has been the discovery, and so urgent the effort to accelerate the drill program (four machines have been moved in since the discovery hole was completed), that assays have been completed on only the discovery. But this must be recorded as one of the most impressive drill holes completed in modern times.

For a core length of a shade better than 600 ft., the hole averaged in excess of 1% copper, 8% zinc and nearly four ounces of silver.

And there are impressive, strong sections within this width which in themselves are quite spectacular. In the upper part of the hole, for example, a core length of 82 ft. ran 7.1% copper, 9.7% zinc and 2.4 ozs. silver. This was followed by continuous values of ore tenor—deeper down, a 100-ft. section runs 0.33% copper, 0.8% lead, 14.3% zinc and 4.2 ozs. silver. And still deeper, a strong zinc section of better than 100 ft. averaged out to in excess of seven ounces of silver in addition to ore-grade zinc values.

diversified, smaller firms, had increased substantially solely on the basis of the discovery of good anomalies or even because of the proximity of their lands to the situs of a potentially major strike.

Finally, a major factor in determining whether the K-55-1 Discovery was a material fact is the importance attached to the drilling results by those who knew about it. In view of other unrelated recent developments favorably affecting TGS, participation by an informed person in a regular stock-purchase program, or even sporadic trading by an informed person, might lend only nominal support to the inference of the materiality of the K-55-1 discovery; nevertheless, the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls—purchases in some cases by individuals who had never before purchased calls or even TGS stock—virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery, was apparently disregarded by the court below in favor of the testimony of defendants' expert witnesses, all of whom "agreed that one drill core does not establish an ore body, much less a mine," 258 F. Supp. at 282-283. Significantly, however, the court below, while relying upon what these defense experts said the defendant insiders *ought* to have thought about the worth to TGS of the K-55-1 discovery, and finding that from November 12, 1963 to April 6, 1964 Fogarty, Murray, Holyk and Darke spent more than $100,000 in purchasing TGS stock and calls on that stock, made no finding that the insiders were motivated by any factor other than the extraordinary K-55-1 discovery when they bought their stock and their calls. No reason appears why outside investors, perhaps better acquainted with spec-

ulative modes of investment and with, in many cases, perhaps more capital at their disposal for intelligent speculation, would have been less influenced, and would not have been similarly motivated to invest if they had known what the insider investors knew about the K-55-1 discovery.

Our decision to expand the limited protection afforded outside investors by the trial court's narrow definition of materiality is not at all shaken by fears that the elimination of insider trading benefits will deplete the ranks of capable corporate managers by taking away an incentive to accept such employment. Such benefits, in essence, are forms of secret corporate compensation, see Cary, Corporate Standards and Legal Rules, 50 Calif. L. Rev. 408, 409-10 (1962), derived at the expense of the uninformed investing public and not at the expense of the corporation which receives the sole benefit from insider incentives. Moreover, adequate incentives for corporate officers may be provided by properly administered stock options and employee purchase plans of which there are many in existence. In any event, the normal motivation induced by stock ownership, i.e., the identification of an individual with corporate progress, is ill-promoted by condoning the sort of speculative insider activity which occurred here; for example, some of the corporation's stock was sold at market in order to purchase short-term calls upon that stock, calls which would never be exercised to increase a stockholder equity in TGS unless the market price of that stock rose sharply.

The core of Rule 10b-5 is the implementation of the Congressional purpose that all investors should have equal access to the rewards of participation in securities transactions. It was the intent of Congress that all members of the investing public should be subject to identical market risks,—which market risks include, of course the risk that one's evaluative capacity or one's capital available to put

at risk may exceed another's capacity or capital. The insiders here were not trading on an equal footing with the outside investors. They alone were in a position to evaluate the probability and magnitude of what seemed from the outset to be a major ore strike; they alone could invest safely, secure in the expectation that the price of TGS stock would rise substantially in the event such a major strike should materialize, but would decline little, if at all, in the event of failure, for the public, ignorant at the outset of the favorable probabilities would likewise be unaware of the unproductive exploration, and the additional exploration costs would not significantly affect TGS market prices. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in view of the congressional concern in the area, remain uncorrected.

We hold, therefore, that all transactions in TGS stock or calls by individuals apprised of the drilling results[14] of K-55-1 were made in violation of Rule 10b-5.[15] Inasmuch as the visual evaluation of that drill core (a generally reliable estimate though less accurate than a chemical assay) constituted material information, those advised of the results of the visual evaluation as well as those informed of the chemical assay traded in violation of law. The geologist Darke possessed undisclosed material information and

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14 The trial court found that defendant Murray "had no detailed knowledge as to the work" on the Kidd-55 segment. There is no evidence in the record suggesting that Murray purchased his stock on January 8, 1964, on the basis of material undisclosed information, and the disposition below is undisturbed as to him.

15 Even if insiders were in fact ignorant of the broad scope of the Rule and acted pursuant to a mistaken belief as to the applicable law such an ignorance does not insulate them from the consequences of their acts. *Tager* v. *SEC*, 344 F. 2d 5, 8 (2 Cir. 1965).

traded in TGS securities. Therefore we reverse the dismissal of the action as to him and his personal transactions. The trial court also found, 258 F. Supp. at 284, that Darke, after the drilling of K-55-1 had been completed and with detailed knowledge of the results thereof, told certain outside individuals that TGS "was a good buy." These individuals thereafter acquired TGS stock and calls. The trial court also found that later, as of March 30, 1964, Darke not only used his material knowledge for his own purchases but that the substantial amounts of TGS stock and calls purchased by these outside individuals on that day, see footnote 4, *supra,* was "strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed." 258 F. Supp. at 284. Obviously if such a resumption were to have any meaning to such "tippees," they must have previously been told of K-55-1.

Unfortunately, however, there was no definitive resolution below of Darke's liability in these premises for the trial court held as to him, as it held as to all the other individual defendants, that this "undisclosed information" never became material until April 9. As it is our holding that the information acquired after the drilling of K-55-1 was material, we, on the basis of the findings of direct and circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5(3) and Section 10(b) by "tipping" and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy.[16] As Darke's "tippees" are not defen-

16 Judges Waterman and Anderson, believing that there had been no definitive finding below as to whether Darke, expressly or by implication, transmitted to these outsiders any indication of the extremely favorable results of the drilling operation in which he was engaged, would remand

dants in this action, we need not decide whether, if they acted with actual or constructive knowledge that the material information was undisclosed, their conduct is as equally violative of the Rule as the conduct of their insider source, though we note that it certainly could be equally reprehensible.

With reference to Huntington, the trial court found that he "had no detailed knowledge as to the work" on the Kidd-55 segment, 258 F. Supp. 281. Nevertheless, the evidence shows that he knew about and participated in TGS's land acquisition program which followed the receipt of the K-55-1 drilling results, and that on February 26, 1964 he purchased 50 shares of TGS stock. Later, on March 16, he helped prepare a letter for Dr. Holyk's signature in which TGS made a substantial offer for lands near K-55-1, and on the same day he, who had never before purchased calls on any stock, purchased a call on 100 shares of TGS stock. We are satisfied that these purchases in February and March, coupled with his readily inferable and probably reliable, understanding of the highly favorable nature of preliminary operations on the Kidd segment, demonstrate that Huntington possessed material inside information such as to make his purchase violative of the Rule and the Act.

C. *When May Insiders Act?*

Appellant Crawford, who ordered[17] the purchase of TGS stock shortly before the TGS April 16 official announce-

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for a determination on this issue, and if it should be determined that Darke did make such revelations, for a determination of the appropriate remedy.

17 The effective protection of the public from insider exploitation of advance notice of material information requires that the time that an insider places an order, rather than the time of its ultimate execution, be determinative for Rule 10b-5 purposes. Otherwise, insiders would

ment, and defendant Coates, who placed orders with and communicated the news to his broker immediately after the official announcement was read at the TGS-called press conference, concede that they were in possession of material information. They contend, however, that their purchases were not proscribed purchases for the news had already been effectively disclosed. We disagree.

Crawford telephoned his orders to his Chicago broker about midnight on April 15 and again at 8:30 in the morning of the 16th, with instructions to buy at the opening of the Midwest Stock Exchange that morning. The trial court's finding that "he sought to, and did, 'beat the news,'" 258 F. Supp. at 287, is well documented by the record. The rumors of a major ore strike which had been circulated in Canada and, to a lesser extent, in New York, had been disclaimed by the TGS press release of April 12, which significantly promised the public an official detailed announcement when possibilities had ripened into actualities. The abbreviated announcement to the Canadian press at 9:40 A.M. on the 16th by the Canadian Minister of Mines and the report carried by *The Northern Miner*, parts of which had sporadically reached New York on the morning of the 16th through reports from Canadian affiliates to a few New York investment firms, are assuredly not the equivalent of the official 10-15 minute announcement which was not released to the American financial press until after 10:00 A.M. Crawford's orders had been placed before that. Be-

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be able to "beat the news," cf. Fleischer, *supra*, 51 Va. L. Rev. at 1291, by requesting in advance that their orders be executed immediately after the dissemination of a major news release but before outsiders could act on the release. Thus it is immaterial whether Crawford's orders were executed before or after the announcement was made in Canada (9:40 A.M., April 16) or in the United States (10:00 A.M.) or whether Coates's order was executed before or after the news appeared over the Merrill Lynch (10:29 A.M.) or Dow Jones (10:54 A.M.) wires.

fore insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public. Particularly here, where a formal announcement to the entire financial news media had been promised in a prior official release known to the media, all insider activity must await dissemination of the promised official announcement.

Coates was absolved by the court below because his telephone order was placed shortly before 10:20 A.M. on April 16, which was after the announcement had been made even though the news could not be considered already a matter of public information. 258 F. Supp. at 288. This result seems to have been predicated upon a misinterpretation of dicta in *Cady, Roberts,* where the SEC instructed insiders to "keep out of the market until the established procedures for public release of the information are *carried out* instead of hastening to execute transactions in advance of, and in frustration of, the objectives of the release," 40 SEC at 915 (emphasis supplied). The reading of a news release, which prompted Coates into action, is merely the first step in the process of dissemination required for compliance with the regulatory objective of providing all investors with an equal opportunity to make informed investment judgments. Assuming that the contents of the official release could instantaneously be acted upon,[18] at the minimum

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18 Although the only insider who acted after the news appeared over the Dow Jones broad tape is not an appellant and therefore we need not discuss the necessity of considering the advisability of a "reasonable waiting period" during which outsiders may absorb and evaluate disclosures, we note in passing that, where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination. In any event, the permissible timing of insider transactions after disclosures of various sorts is one of the many areas of expertise for appropriate exercise of the SEC's rule-making power, which we hope will be utilized in the future to provide some predictability or certainty for the business community.

Coates should have waited until the news could reasonably have been expected to appear over the media of widest circulation, the Dow Jones broad tape, rather than hastening to insure an advantage to himself and his oker son-in-law.[19]

D. *Is An Insider's Good Faith A Defense Under 10b-5?*

Coates, Crawford and Clayton, who ordered purchases before the news could be deemed disclosed, claim, nevertheless, that they were justified in doing so because they honestly believed that the news of the strike had become public at the time they placed their orders. However, whether the case before us is treated solely as an SEC enforcement proceeding or as a private action,[20] proof of a specific intent to defraud is unnecessary. In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the investing public so that negligent insider conduct has become unlawful. See *Berko* v. *SEC*, 316 F. 2d 137, 141-42 (2 Cir.

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19 The record reveals that news usually appears on the Dow Jones broad tape 2-3 minutes after the reporter completes dictation. Here, assuming that the Dow Jones reporter left the press conference as early as possible, 10:10 A.M., the 10-15 minute release (which took at least that long to dictate) could not have appeared on the wire before 10:22, and for other reasons unknown to us did not appear until 10:54. Indeed, even the abbreviated version of the release reported by Merrill Lynch over its private wire did not appear until 10:29. Coates, however, placed his call no later than 10:20.

20 The SEC seeks permanent injunctions restraining future proscribed activity by all the individual defendants and the corporation. The Commission also seeks court orders upon certain of the individual defendants that are essentially remedies of a private, rather than of a regulatory nature, court orders designed to have those individual defendants disgorge any profits they enjoyed from TGS stock transactions they or their "tippees" engaged in from November 12, 1963 to April 17, 1964.

1963); *SEC* v. *Capital Gains Bureau,* 375 U. S. 180, 193 (1963). A similar standard has been adopted in private actions, see, *e.g., Stevens* v. *Vowell,* 343 F. 2d 374 (10 Cir. 1965); *Ellis* v. *Carter,* 291 F. 2d 270 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith,* 312 F. 2d 210 (9 Cir. 1962); *Dack* v. *Shanman,* 227 F. Supp. 26 (SDNY 1964); but see, *e.g., Weber* v. *C. M. P. Corp.,* 242 F. Supp. 321 (SDNY 1965); *Thiele* v. *Shields,* 131 F. Supp. 416 (SDNY 1955), for policy reasons which seem perfectly consistent with the broad Congressional design ". . . to insure the maintenance of fair and honest markets in . . . [securities] transactions." Sec. 2 of SEC Act, 15 U. S. C. §78b, see *Kohler* v. *Kohler Co.,* 319 F. 2d 634, 642 (7 Cir. 1963); Note, 32 U. Chi. L. Rev. 824, 839-44 (1965); Note, 63 Mich. L. Rev. 1070, 1079-81 (1965).

Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent, see Note, 63 Mich. L. Rev. 1070, 1075, 1076 n. 29 (1965), the securities laws should be interpreted as an expansion of the common law[21] both to effectuate the broad remedial design of Congress, see *SEC* v. *Capital Gains Research Bureau, supra* at 195, and to insure uniformity of enforcement, see Note, 32 U. Chi. L. Rev. 824, 832 n. 36 (1965), citing *McClure* v. *Borne Chemical Co.,* 292 F. 2d 824, 834 (3 Cir. 1961). Moreover, a review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses

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21 Even at common law, the essentially private remedy of rescission which is sought here does not require more than a showing of negligence and frequently even less than that, see Restatement, Contracts, §476, com b (1932); and the common law concept of constructive fraud still available to private plaintiffs, see *Trussell* v. *United Underwriters, Ltd.,* 228 F. Supp. 757, 772 (D. Colo. 1964), has been expanded from recklessness, see Prosser, Torts, §102 p. 715-17 (3d ed. 1964), to include non-reckless negligent misrepresentations or omissions, see Note, 63 Mich. L. Rev. 1070, 1079.

negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule.[22] Finally, we note that this position is not, as asserted by defendants, irreconcilable with previous language in this circuit because "*some form* of the traditional scienter requirement," *Barnes* v. *Osofsky*, 373 F. 2d 269, 272 (2 Cir. 1967), (emphasis supplied), sometimes defined as "fraud," *Fischman* v. *Raytheon Mfg. Co.*, 9 F. R. D. 707 (SDNY 1949), *rev'd on other grounds*, 188 F. 2d 783, 786 (2 Cir. 1951) is preserved. This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule.

Thus, the beliefs of Coates, Crawford and Clayton that the news of the ore strike was sufficiently public at the time of their purchase orders are to no avail if those beliefs were no reasonable under the circumstances. Crawford points to the scattered rumors of the discovery which had been circulating for some time before April 15, to the release of the information to *The Northern Miner* on April

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22 Liability under §12(2) of the Securities Act of 1933, 15 U. S. C. §77*l*(2), the language of which is strikingly similar to that of 10b-5(2), attaches from the mere fact of misrepresentation or misleading omission unless defendant proves that "he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." The provisions of Sections 17(a)(2) and (3) of the Securities Act of 1933, 15 U. S. C. §77q(a)(2) and (3), which are virtually identical to the provisions of Rule 10b-5(2) and (3) and were, in fact, the model therefor, see *Birnbaum* v. *Newport Steel Corp.*, 193 F. 2d 461, 463 (2 Cir.), cert. denied, 343 U. S. 956 (1952); *Hooper* v. *Mountain States Sec. Corp.*, 282 F. 2d 195, 201 n. 4 (5 Cir. 1960), cert. denied, 365 U. S. 814 (1961), apply criminal penalties to sellers only (Rule 10b-5 was promulgated to fill this gap in enforcement, SEC Ann. Rep. 10 (1942)), and have been read, upon close scrutiny of their legislative history, as not requiring specific fraudulent intent, *SEC* v. *Van Horn*, 371 F. 2d 181, at 184-186 (7 Cir. 1966); *United States* v. *Schaefer*, 299 F. 2d 625, 629 (7 Cir. 1962) (lack of diligence is all that is required for conviction in a criminal prosecution for violation of §17(a) of the 1933 Act.

15 to be published by it on the 16th, to the arrangement made by TGS with the Ontario Minister of Mines for the release of an abbreviated report on the evening of the 15th (which did not eventuate until 9:40 A.M., April 16), and to the corporation's official announcement at 10:00 A.M. on the 16th, all of which transpired prior to an anticipated execution of his purchase orders that had been placed by him after trading had closed on the Midwest Exchange on April 15. However, the rumors and casual disclosure through Canadian media, especially in view of the April 12 gloomy or incomplete release denying the rumors and promising official confirmation, hardly sufficed to inform traders on American exchanges affected by Crawford's purchases. Moreover, the formal announcement could not reasonably have been expected to be disseminated by the time of the opening of the exchanges on the morning of April 16, when Crawford must have expected his orders would be executed.

Clayton, who was unaware of the April 16 disclosure announcement TGS was to make can, in support of his claim that the favorable news was public, rely only on the rumors and on the phone calls received by TGS prior to the placing of his order from those who seemed to have heard some version or rumors of the news. His awareness of the contents of the April 12 release renders unreasonable any claim that he believed the news was truly public.

Finally, Coates, as we have already indicated in fn. 19, *supra,* could not reasonably have expected the official release to have been disseminated when he placed his order before 10:20 for immediate execution nor were the Canadian disclosures relied on by Crawford sufficient to render the conduct of Coates permissible under the circumstances.[23]

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23 Coates's violations encompass not only his own purchases but also the purchases by his son-in-law and the customers of his son-in-law, to whom the material information was passed. See footnote 16, *supra.*

E. *May Insiders Accept Stock Options Without Disclosing Material Information To The Issuer?*

On February 20, 1964, defendants Stephens, Fogarty, Mollison, Holyk and Kline accepted stock options issued to them and a number of other top officers of TGS, although not one of them had informed the Stock Option Committee of the Board of Directors or the Board of the results of K-55-1, which information we have held was then material. The SEC sought rescission of these options. The trial court, in addition to finding the knowledge of the results of the K-55 discovery to be immaterial, held that Kline had no detailed knowledge of the drilling progress and that Holyk and Mollison could reasonably assume that their superiors, Stephens and Fogarty, who were directors of the corporation, would report the results if that was advisable; indeed all employees had been instructed not to divulge this information pending completion of the land acquisition program, 258 F. Supp. at 291. Therefore, the court below concluded that only directors Stephens and Fogarty, of the top management, would have violated the Rule by accepting stock options without disclosure, but it also found that they had not acted improperly as the information in their possession was not material. 258 F. Supp. at 292. In view of our conclusion as to materiality we hold that Stephens and Fogarty violated the Rule by accepting them. However, as they have surrendered the options and the corporation has canceled them, *supra* at 292, n. 17, we find it unnecessary to order that the injunctions prayed for be actually issued. We point out, nevertheless, that the surrender of these options after the SEC commenced the case is not a satisfaction of the SEC claim, and a determination as to whether the issuance of injunctions against Stephens and Fogarty is advisable in order to prevent or deter future violations of regulatory provi-

sions is remanded for the exercise of discretion by the trial court.

Contrary to the belief of the trial court that Kline had no duty to disclose his knowledge of the Kidd project before accepting the stock option offered him, we believe that he, a vice president, who had become the general counsel of TGS in January 1964, but who had been secretary of the corporation since January 1961, and was present in that capacity when the options were granted, and who was in charge of the mechanics of issuance and acceptance of the options, was a member of top management and under a duty before accepting his option to disclose any material information he may have possessed, and, as he did not disclose such information to the Option Committee we direct rescission of the option he received.[24] As to Holyk and

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24 The options granted on February 20, 1964 to Mollison, Holyk, and Kline were ratified by the Texas Gulf directors on July 15, 1965 after there had been, of course, a full disclosure and after this action had been commenced. However, the ratification is irrelevant here, for we would hold with the district court that a member of top management, as was Kline, is required, before accepting a stock option, to disclose material inside information which, if disclosed, might affect the price of the stock during the period when the accepted option could be exercised. Kline had known since November 1962 that K-55-1 had been drilled, that the drilling had intersected a sulphide body containing copper and zinc, and that TGS desired to acquire adjacent property.

Of course, if any of the five knowledgeable defendants had rejected his option there might well have been speculation as to the reason for the rejection. Therefore, in a case where disclosure to the grantors of an option would seriously jeopardize a corporate security, it could well be desirable, in order to protect a corporation from selling securities to insiders who are in a position to appreciate their true worth at a price which may not accurately reflect the true value of the securities and at the same time to preserve when necessary the secrecy of corporate activity, not to require that an insider possessed of undisclosed material information reject the offer of a stock option, but only to require that he abstain from exercising it until such time as there shall have been a full disclosure and, after the full disclosure, a ratification such as was voted here. However, as this suggestion was not presented to us, we do not consider it or make any determination with reference to it.

Mollison, the SEC has not appealed the holding below that they, not being then members of top management (although Mollison was a vice president) had no duty to disclose their knowledge of the drilling before accepting their options. Therefore, the issue of whether, by accepting, they violated the Act, is not before us, and the holding below is undisturbed.

II. The Corporate Defendant

Introductory

At 3:00 P.M. on April 12, 1964, evidently believing it desirable to comment upon the rumors concerning the Timmins project, TGS issued the press release quoted in pertinent part in the text at pages 3600-3601, *supra*. The SEC argued below and maintains on this appeal that this release painted a misleading and deceptive picture of the drilling progress at the time of its issuance, and hence violated Rule 10b-5(2).[25] TGS relies on the holding of the court below that "The issuance of the release produced no unusual market action" and "In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security'" and, alternatively, "even if it had been established that the April 12 release was issued in connec-

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25 Rule 10b-5(2) provides in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, . . .
>
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, . . .
>
> in connection with the purchase or sale of any security.

tion with the purchase or sale of any security, the Commission has failed to demonstrate that it was false, misleading or deceptive." 258 F. Supp. at 294.

Before further discussing this matter it seems desirable to state exactly what the SEC claimed in its complaint and what it seeks. The specific SEC allegation in its complaint is that this April 12 press release ". . . was materially false and misleading and was known by certain of defendant Texas Gulf's officers and employees, including defendants Fogarty, Mollison, Holyk, Darke and Clayton, to be materially false and misleading."

The specific relief the SEC seeks is, pursuant to Section 21(e) of Securities Exchange Act of 1934, 15 U. S. C. §78u(e), a permanent injunction restraining the issuance of any further materially false and misleading publicly distributed informative items.[26]

B. *The "In Connection With . . ." Requirement.*

In adjudicating upon the relationship of this phrase to the case before us it would appear that the court below used a standard that does not reflect the congressional purpose that prompted the passage of the Securities Exchange Act of 1934.

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26 The prayer for relief reads:

WHEREFORE the plaintiff prays for:

* * * * *

(5) The issuance of a final judgment permanently enjoining the defendant Texas Gulf from directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, in connection with the purchase or sale of securities, making any untrue statement of material fact or omitting to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading, namely, from issuing, publishing, distributing or otherwise disseminating materially false, misleading, inadequate or inaccurate press releases and other communications and reports concerning material facts about Texas Gulf's activities and operations.

The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases. Commenting on the disclosure purposes of the House bill (H. R. 9323), the bill a Committee of Conference eventually integrated with a similar Senate bill (S. 3420) to make the bill passed by both Houses of Congress that became the Securities Exchange Act of 1934, the House Committee which reported out H. R. 9323 stated:

> The idea of a free and open public market is built upon the theory that competing judgments of buyers and sellers as to the fair price of a security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. *There cannot be honest markets without honest publicity.* Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. Delayed, inaccurate, and misleading reports are the tools of the unconscionable market operator and the recreant corporate official who speculate on inside information. Despite the tug

> of conflicting interests and the influence of popular groups, responsible officials of the leading exchanges have unqualifiedly recognized in theory at least the vital importance of *true and accurate corporate reporting as an essential cog in the proper functioning of the public exchanges.* Their efforts to bring about more adequate and prompt publicity have been handicapped by the lack of legal power and by the failure of certain banking and business groups to appreciate that a business that gathers its capital from the investing public has not the same right to secrecy as a small privately owned and managed business. It is only a few decades since men believed that the disclosure of a balance sheet was a disclosure of a trade secret. Today few people would admit the right of any company to solicit public funds without the disclosure of a balance sheet. (Emphasis supplied.) H. R. Rep. No. 1383, 73rd Cong., 2d Sess. 11 (1934).

Section 10b of the Act (see footnote 8, *supra*) was taken by the Conference Committee from Section 10b of the proposed Senate bill, S. 3420, and taken from it verbatim insofar as here pertinent. The only alteration made by the Conference Committee was to substitute the present closing language of Section 10b, ". . . in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors" for the closing language of the original Section 10b of S. 3420, ". . . which the Commission may declare to be detrimental to the interests of investors." 78 Cong. Rec. 10261 (1934).

The Report of the Senate Committee which presented S. 3420 to the Senate summarized Section 10b as follows:

> Subsection (b) authorizes the Commission by rules and regulations to prohibit or regulate the use of *any other manipulative or deceptive practices which it finds detrimental to the interests of the investor.* (Emphasis supplied.)
>
> S. Rep. No. 792, 73rd Cong., 2d Sess. 18 (1934).

Indeed, from its very inception, Section 10(b), and the proposed sections in H. R. 1383 and S. 3420 from which it was derived, have always been acknowledged as catch-alls. See Bromberg, Securities Law: SEC Rule 10b-5, p. 19 (1967). In the House Committee hearings on the proposed House bill, Thomas G. Corcoran, Counsel with the Reconstruction Finance Corporation and a spokesman for the Roosevelt Administration, described the broad prohibitions contained in §9(c), the section which corresponded to Section 10(b) of S. 3420 and eventually to Section 10(b) of the Act, as follows: "Subsection (c) says, 'Thou shalt not devise any other cunning devices' . . . . Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices." Stock Exchange Regulation, Hearings before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess. 115 (1934). Although several other witnesses objected to the breadth of the proposed prohibition that Corcoran was supporting, the section as enacted did not in any way limit the broad scope of the "in connection with" phrase. See 3 Loss, Securities Regulation, 1424 n. 7 (2d ed. 1961).

Thus, the legislative history of Section 10(b) does not support the proposition urged upon us by Texas Gulf Sulphur that Congress intended the limited construction of the "in connection with" phrase applied by the trial court.

Moreover, comparisons of Section 10(b) with the antifraud provisions of the Securities Act of 1933 (§12(2), 15 U. S. C. §77*l*(2) "... [offers or] sells a security by means of ..."; §17(a), 15 U. S. C. §77q(a) "... in the [offer or] sale of any securities to obtain money or property by means of ..."; [language in brackets was added in 1954 amendments]), and with the 1936 antifraud amendment of Section 15 of the Securities Exchange Act of 1934 (§15(c)(1), 15 U. S. C. §78*o*(c)(1) "... effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security ...") demonstrate that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear. See Bromberg, *op. cit. supra* Table 1 at 16-17.

Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase "in connection with a purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of a misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the Act to protect the investing public and to secure fair dealing in the securities markets would be seriously undermined by applying such a gloss onto the legislative language. Absent a securities transaction by an insider it is almost impossible to prove that a wrongful purpose moti-

vated the issuance of the misleading statement. The mere fact that an insider did not engage in securities transactions does not negate the possibility of wrongful purpose; perhaps the market did not react to the misleading statement as much as was anticipated or perhaps the wrongful purpose was something other than the desire to buy at a low price or sell at a high price. Of even greater relevance to the Congressional purpose of investor protection is the fact that the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose. We do not believe that Congress intended that the proscriptions of the Act would not be violated unless the makers of a misleading statement also participated in pertinent securities transactions in connection therewith, or unless it could be shown that the issuance of the statement was motivated by a plan to benefit the corporation or themselves at the expense of a duped investing public.

Nor is there anything about Rule 10b-5 which demonstrates that the SEC sought by the Rule not fully to implement the Congressional purpose and objectives underlying Section 10(b). See Securities Exchange Act of 1934, Release No. 3230 (May 21, 1942); 10 SEC Ann. Rep. 56-7 (1944); 8 SEC Ann. Rep. 10 (1942). To be sure, SEC official publicity accompanying the promulgation of the Rule emphasized the insider trading aspects of the Rule, particularly the prohibition against purchases by insiders, but this was emphasized because "the previously existing rules against fraud in the purchase of securities applied only to brokers and dealers," 8 SEC Ann. Rep. 10, and the Commission wished to make it emphatically clear that the Rule was expected, *inter alia*, to close this loophole.

The foregoing discussion demonstrates that Congress intended to protect the investing public in connection with their purchases or sales on Exchanges from being misled by misleading statements promulgated for or on behalf of corporations irrespective of whether the insiders contemporaneously trade in the securities of that corporation and irrespective of whether the corporation or its management have an ulterior purpose or purposes in making an official public release. Indeed, the Commission has been charged by Congress with the responsibility of policing all misleading corporate statements from those contained in an initial prospectus to those contained in a notice to stockholders relative to the need or desirability of terminating the existence of a corporation or of merging it with another. To render the Congressional purpose ineffective by inserting into the statutory words the need of proving, not only that the public may have been misled by the release, but also that those responsible were actuated by a wrongful purpose when they issued the release, is to handicap unreasonably the Commission in its work. We should have in mind the wise words of Judge Learned Hand in *Cawley* v. *United States*, 272 F. 2d 443, 445 (2 Cir. 1959), relative to an interpretation of the words contained within a congressional statute, that " . . . unless they explicitly forbid it, the purpose of a statutory provision is the best test of the meaning of the words chosen. We are to put ourselves so far as we can in the position of the legislature that uttered them, and decide whether or not it would declare that the situation that has arisen is within what it wishes to cover. Indeed, at times the purpose may be so manifest as to override even the explicit words used. *Markham* v. *Cabell*, 326 U. S. 404."

As was pointed out by the trial court, 258 F. Supp. at 293, the intent of the Securities Exchange Act of 1934 is

the protection of investors against fraud. Therefore, it would seem elementary that the Commission has a duty to police management so as to prevent corporate practices which are reasonably likely fraudulently to injure investors. And, of course, as we have already emphasized, a corporation's misleading material statement may injure an investor irrespective of whether the corporation itself, or those individuals managing it, are contemporaneously buying or selling the stock of the corporation. Therefore, when materially misleading corporate statements or deceptive insider activities have been uncovered, the courts, as they should, have broadly construed the statutory phrase "in connection with the purchase or sale of any security." *Freed* v. *Szabo Food Serv., Inc.*, CCH Fed. SEC L. Rep. ¶91,317 (N. D. Ill. 1964); *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972, 978 (SDNY 1964); *Miller* v. *Bargain City, U. S. A., Inc.*, 229 F. Supp. 33, 37 (E. D. Pa. 1964); see Ruder, Corporate Disclosures Required by the Federal Securities Laws: The Codification Implications of Texas Gulf Sulphur, 61 Nw. U. L. Rev. 872, 895 (1967). The court below found: "There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage." 258 F. Supp. at 294. The requirement that a statement may not be found misleading unless its issuance is actuated by a "wrongful purpose" might well have the effect of permitting the issuers of misleading statements to seek an advantage but to escape liability if the advantage fails to materialize to the degree contemplated, or cannot be demonstrated.

More important, however, is the realization which we must again underscore at the risk of repetition, that the investing public is hurt by exposure to false or deceptive

statements irrespective of the purpose underlying their issuance.[27] It does not appear to be unfair to impose upon corporate management a duty to ascertain the truth of any statements the corporation releases to its shareholders or to the investing public at large. Accordingly, we hold that Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media, Fleischer, *supra*, 51 Va. L. Rev. at 1294-95, if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. It seems clear, however, that if corporate management demonstrates that it was diligent in ascertaining that the information it published was the whole truth and that such diligently obtained information was disseminated in good faith, Rule 10b-5 would not have been violated.

C. *Did the Issuance of the April 12 Release Violate Rule 10b-5?*

Turning first to the question of whether the release was misleading, i.e., whether it conveyed to the public a false impression of the drilling situation at the time of its issuance, we note initially that the trial court did not actually decide this question. Its conclusion that "the Commission has failed to demonstrate that it was false, misleading or deceptive," 258 F. Supp. at 294, seems to have derived from its views that "The defendants are to be judged *on the facts known to them* when the April 12 release was issued," 258 F. Supp. at 295 (emphasis supplied), that the draftsmen "exercised reasonable business judgment under the

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27 See the discussion in footnotes 20, 21, and 22, *supra*, and in the accompanying text, dispensing with a fraudulent intent requirement in actions based on clause (3) of Rule 10b-5.

circumstances," 258 F. Supp. at 296, and that the release was not "misleading or deceptive *on the basis of the facts then known*," 258 F. Supp. at 296 (emphasis supplied) rather than from an appropriate primary inquiry into the meaning of the statement to the reasonable investor and its relationship to truth. While we certainly agree with the trial court that "in retrospect, the press release may appear gloomy or incomplete," [28] 258 F. Supp. at 296, we

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28 Examined in retrospect, the situation in Timmins at the time the release was prepared seems to offer good reason for optimism. The draftsmen of the release had full knowledge of the discoveries up to 7:00 P.M. on Friday, April 10. At that time approximately 2/3 of the ore ultimately found to exist by the time of the preparation of the April 16 "major strike" release had been discovered by 5 holes placed so as to indicate continuity of mineralization within the large anomaly. As of that time SEC experts estimated ore reserves of over 8 million tons at a gross assay value (excluding costs) of over $26 a ton. Accepting the conservative view of TGS's expert Wiles that 95.2% would be absorbed by costs, the ultimate profit could then have been estimated at more than $14,000,000. TGS experts could name very few base metal mines with a greater assay value and the court observed that bodies of much lower assay value were commercially mined, 258 F. Supp. at 282 n. 10. Roche, a mining stock specialist, added that mines with significantly lower percentages of copper and with no zinc or silver, as here, were profitably operated. On the basis of approximately one-third more data, and, for all the record shows, without any additional figures as to estimated costs, TGS announced on April 16 a major strike with over 25 million tons of ore. The trial court found that as of 7:00 P.M. on Thursday, April 9, "There was real evidence that a body of commercially mineable ore might exist." 252 F. Supp. at 282. And, by 7:00 A.M. on Sunday, April 10, eight hours before the release was issued to the press, 77.9% of the drilling in mineralization had been completed, 84.4% by 7:00 P.M. on the 12th, and 90.2% by 7 A.M. on April 13. The release did not appear in most newspapers of general circulation until later in the morning of Monday, the 13th.

The release, see pp. 3600-3601 *supra*, began by referring to rumored reports that the company had made a substantial copper discovery and then continued: "These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS." It then stated, purporting to give the true facts in contradiction to the rumors: "The facts are as follows." However, the "facts" disclosed relative to the Kidd-55 segment were: "Recent drilling on one property near Timmins has led to preliminary

cannot, from the present record, by applying the standard Congress intended, definitively conclude that it was deceptive or misleading to the reasonable investor, or that he would have been misled by it. Certain newspaper accounts of the release viewed the release as confirming the existence of preliminary favorable developments, and this optimistic view was held by some brokers, so it could be that the reasonable investor would have read between the lines of what appears to us to be an inconclusive and negative statement and would have envisioned the actual situation at the Kidd segment on April 12. On the other hand, in view of the decline of the market price of TGS stock from a high of 32 on the morning of April 13 when the release was disseminated to 29⅜ by the close of trading on April 15, and the reaction to the release by other brokers, it is far from certain that the release was generally interpreted as a highly encouraging report or even encouraging at all. Accordingly, we remand this issue to the district court that took testimony and heard and saw the witnesses for a determination of the character of the release in the light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it.

In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence. The only remedy the Commission seeks against the corporation is an injunction, see footnote 26,

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indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable." It was then said that, as of April 12, the release date, ". . . any statement as to size and grade of ore would be premature and possibly misleading." A definite statement "to clarify" was promised in the future.

supra, and therefore we do not find it necessary to decide whether just a lack of due diligence on the part of TGS, absent a showing of bad faith, would subject the corporation to any liability for damages. We have recently stated in a case involving a private suit under Rule 10b-5 in which damages and an injunction were sought, " 'It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages.' " *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F. 2d 540, 547, quoting from *SEC* v. *Capital Gains Research Bureau, Inc.,* 375 U. S. 180, 193 (1963).

We hold only that, in an action for injunctive relief, the district court has the discretionary power under Rule 10b-5 and Section 10(b) to issue an injunction, if the misleading statement resulted from a lack of due diligence on the part of TGS. The trial court did not find it necessary to decide whether TGS exercised such diligence and has not yet attempted to resolve this issue. While the trial court concluded that TGS had exercised "reasonable *business* judgment under the circumstances," 258 F. Supp. at 296 (emphasis supplied) it applied an incorrect *legal* standard in appraising whether TGS should have issued its April 12 release on the basis of the facts known to its draftsmen at the time of its preparation, 258 F. Supp. at 295, and in assuming that disclosure of the full underlying facts of the Timmins situation was not a viable alternative to the vague generalities which were asserted. 258 F. Supp. at 296.

It is not altogether certain from the present record that the draftsmen could, as the SEC suggests, have readily obtained current reports of the drilling progress over the weekend of April 10-12, but they certainly should have obtained them if at all possible for them to do so. However, even if it were not possible to evaluate and transmit

current data in time to prepare the release on April 12, it would seem that TGS could have delayed the preparation a bit until an accurate report of a rapidly changing situation was possible. See 258 F. Supp. at 296. At the very least, if TGS felt compelled to respond to the spreading rumors of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and that the release was prepared as of April 10 information rather than purporting to report the progress "to date." Moreover, it would have obviously been better to have specifically described the known drilling progress as of April 10 by stating the basic facts. Such an explicit disclosure would have permitted the investing public to evaluate the "prospect" of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement.

The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency. The avoidance of liability for misrepresentation in the event that the Timmins project failed, a highly unlikely event as of April 12 or April 13, did not forbid the accurate and truthful divulgence of detailed results which need not, of course, have been accompanied by conclusory assertions of success. Nor is it any justification that such an explicit disclosure of the truth might have "encouraged the rumor mill which they were seeking to allay." 258 F. Supp. at 296.

We conclude, then, that, having established that the release was issued in a manner reasonably calculated to affect the market price of TGS stock and to influence the investing public, we must remand to the district court to decide whether the release was misleading to the reasonable investor and if found to be misleading, whether the court in its discretion should issue the injunction the SEC seeks.

CONCLUSION

In summary, therefore, we affirm the finding of the court below that appellants Richard H. Clayton and David M. Crawford have violated 15 U. S. C. §78j(b) and Rule 10b-5; we reverse the judgment order entered below dismissing the complaint against appellees Charles F. Fogarty, Richard H. Clayton, Richard D. Mollison, Walter Holyk, Kenneth H. Darke, Earl L. Huntington, and Francis G. Coates, as we find that they have violated 15 U. S. C. §78j(b) and Rule 10b-5. As to these eight individuals we remand so that in accordance with the agreement between the parties the Commission may notice a hearing before the court below to determine the remedies to be applied against them. We reverse the judgment order dismissing the complaint against Claude O. Stephens, Charles F. Fogarty, and Harold B. Kline as recipients of stock options, direct the district court to consider in its discretion whether to issue injunction orders against Stephens and Fogarty, and direct that an order issue rescinding the option granted Kline and that such further remedy be applied against him as may be proper by way of an order of restitution; and we reverse the judgment dismissing the complaint against Texas Gulf Sulphur Company, remand the cause as to it for a further determination below, in the light of the approach explicated by us in the foregoing opinion, as to whether, in the exercise of its discretion, the injunction against it which the Commission seeks should be ordered.

FRIENDLY, *Circuit Judge* (concurring):

Agreeing with the result reached by the majority and with most of Judge Waterman's searching opinion, I take a rather different approach to two facets of the case.

I.

The first is a situation that will not often arise, involving as it does the acceptance of stock options during a period when inside information likely to produce a rapid and substantial increase in the price of the stock was known to some of the grantees but unknown to those in charge of the granting. I suppose it would be clear, under *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2 Cir. 1964),[1] that if a corporate officer having such knowledge persuaded an unknowing board of directors to grant him an option at a price approximating the current market, the option would be rescindable in an action under Rule 10b-5. It would seem, by the same token, that if, to make the pill easier to swallow, he urged the directors to include others lacking the knowledge he possessed, he would be liable for all the resulting damage. The novel problem in the instant case is to define the responsibility of officers when a directors' committee

1 Since none of the parties has raised the question, I assume the continuing vitality of *Ruckle*, despite what have been regarded as contrary intimations in *O'Neill* v. *Maytag*, 339 F. 2d 764 (2 Cir. 1964), a decision that has not found favor with other circuits. Cf. *Dasho* v. *The Susquehanna Corp.*, 380 F. 2d 262 (7 Cir.), cert. denied, 381 U. S. 977 (1967); *Pappas* v. *Moss*, 393 F. 2d 865 (3 Cir. 1968); see Jennings, Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations under Rule 10b-5, 62 Nw. U. L. Rev. 809, 830-33 (1968). If we were writing on a clean slate, I would have some doubt whether the framers of the Securities Exchange Act intended §10b to provide a remedy for an evil that had long been effectively handled by derivative actions for waste of corporate assets under state law simply because in a particular case the waste took the form of a sale of securities. We will shortly be exploring this issue in the *in banc* consideration of *Schoenbaum* v. *Firstbrook*, slip opinions 2459.

administering a stock option plan proposes of its own initiative to make options available to them and others at a time when they know that the option price, geared to the market value of the stock, did not reflect a substantial increment likely to be realized in short order and was therefore unfair to the corporation.

A rule requiring a minor officer to reject an option so tendered would not comport with the realities either of human nature or of corporate life. If the SEC had appealed the ruling dismissing this portion of the complaint as to Holyk and Mollison, I would have upheld the dismissal quite apart from the special circumstance that a refusal on their part could well have broken the wall of secrecy it was important for TGS to preserve. Whatever they knew or didn't know about Timmins, they were entitled to believe their superiors had reported the facts to the Option Committee unless they had information to the contrary. Stephens, Fogarty and Kline stand on an altogether different basis; as senior officers they had an obligation to inform the Committee that this was not the right time to grant options at 95% of the current price. Silence, when there is a duty to speak, can itself be a fraud. I am unimpressed with the argument that Stephens, Fogarty and Kline could not perform this duty on the peculiar facts of this case, because of the corporate need for secrecy during the land acquisition program. Non-management directors would not normally challenge a recommendation for postponement of an option plan from the President, the Executive Vice President, and the Vice President and General Counsel. Moreover, it should be possible for officers to communicate with directors, of all people, without fearing a breach of confidence. Hence, as one of the foregoing hypotheticals suggests, I am not at all sure that a company in the position

of TGS might not have a claim against top officers who breached their duty of disclosure for the entire damage suffered as a result of the untimely issuance of options, rather than merely one for rescission of the options issued to them.[2] Since that issue is not before us, I merely make the reservation of my position clear.

II.

The second point, to me transcending in public importance all others in this important case, is the press release issued by TGS on April 12, 1964. This seems to me easier on the facts but harder on the law than it does to the majority.

No one has asserted, or reasonably could assert, that the purpose for issuing a release was anything but good. TGS felt it had a responsibility to protect would-be buyers of its shares from what it regarded as exaggerated rumors first in the Canadian and then in the New York City press, and none of the individual defendants sought to profit from the decline in the price of TGS stock caused by the release. I find it equally plain, as Judge Waterman's opinion convincingly demonstrates, that the release did not properly convey the information in the hands of the draftsmen on April 12, even granting, as I would, that in a case like this

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2 Though the Board of Directors of TGS ratified the issuance of the options after the Timmins discovery had been fully publicized, it obviously was of the belief that Kline had committed no serious wrong in remaining silent. Throughout this litigation TGS has supported the legality of the actions of all the defendants—the company's counsel having represented, among others, Stephens, Fogarty and Kline. Consequently, I agree with the majority in giving the Board's action no weight here. If a fraud of this kind may ever be cured by ratification, compare *Continental Securities* v. *Belmont*, 206 N. Y. 7 (1912), with *Claman* v. *Robertson*, 164 Ohio St. 61 (Sup. Ct. 1955); cf. *Wilko* v. *Swan*, 346 U. S. 427 (1953), that cannot be done without an appreciation of the illegality of the conduct proposed to be excused, cf. *United Hotels Co.* v. *Mealey*, 147 F. 2d 816, 819 (2 Cir. 1945).

a court should not set the standard of care too high. To say that the drilling at Timmins had afforded only "preliminary indications that more drilling would be required for proper evaluation of this prospect," was a wholly insufficient statement of what TGS knew. Cf. *Gediman* v. *Anheuser Busch, Inc.*, 299 F. 2d 537, 545 (2 Cir. 1962). Since the issue of negligence is open to full review, *Mamiye Bros.* v. *Barber SS. Lines*, 360 F. 2d 774 (2 Cir.), cert. denied, 385 U. S. 835 (1965); *Esso Standard Oil, S.A.* v. *S.S. Gasbras Sul*, 387 F. 2d 573 (2 Cir.), cert. denied, 36 L. W. 3443 (May 21, 1968), I see no need for a remand on that score. It is an equally needless exercise to require the district court to determine whether a reasonable investor would have been misled. The text of the release and the three point drop in the market price following its issuance in the face of press reports that would normally have led to a large and, as matters developed, justified increase, are sufficient proof of that.

The majority says that negligent misstatement by a corporation is enough for injunctive relief under Rule 10b-5 (2) in a proper case; it reserves the question, not here presented, whether the corporation is liable for damages. I think the remand should make crystal clear that the issue whether this is a proper case for an injunction remains open, and that with 49 private actions pending in the District Court for the Southern District of New York, see 258 F. Supp. 262, 267 n. 1 (1966), some of which may involve this issue, we should explicate more clearly why, despite the principle that a violation of the securities laws or regulations generally gives rise to a private claim for damages, see *J. I. Case Co.* v. *Borak*, 377 U. S. 426 (1964), violation of Rule 10b-5(2) may not do so under all circumstances, including those presented by the April 12 press release.

The attention this case has received from the profession and our own close consideration make it incumbent on us to give the district courts in our circuit as much guidance as we can.

A.

The consequences of holding that negligence in the drafting of a press release such as that of April 12, 1964, may impose civil liability on the corporation are frightening. As has been well said of a situation where time pressures and consequent risks were less, "One source of perplexity as to the appropriate bounds of the civil remedy for misleading filings is that any remedy imposed against the issuer itself is indirectly imposed on all holders of the common stock, usually the most important segment of the total category of investors intended to be protected." Milton Cohen, Truth in Securities Revisited, 79 Harv. L. Rev. 1340, 1370 (1966). Beyond this, a rule imposing civil liability in such cases would work directly counter to what the SEC has properly called "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments." Securities Act Interpretation Release No. 3844 (Oct. 8, 1957). If the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former.

The derivation of Rule 10b-5 is peculiar. Although the authority for the Rule comes from §10b of the Securities

and Exchange Act of 1934, the draftsmen turned their backs on the language of that section and borrowed the words of §17 of the Securities Act of 1933, simply broadening these to include frauds on the seller as well as on the buyer. So far as concerns paragraphs (1) and (3), this is not very important since these are clearly within the ambit of §10b and relate to frauds that would give rise to civil liability in any event. But the case stands differently as to paragraph (2). The only provision in either the 1933 or the 1934 Act that can be read to impose liability for damages for negligent misrepresentation without restrictions as to the kinds of plaintiffs, due diligence defenses, a short statute of limitations, or an undertaking for costs that were insisted on by the investment community, is §17(a)(2) of the Act of 1933—the source of Rule 10b-5(2).[3] But there is unanimity among the commentators, including some who were in a peculiarly good position to know, that §17(a)(2) of the 1933 Act—indeed the whole of §17—was intended only to afford a basis for injunctive relief and, on a proper showing, for criminal liability, and was never believed to supplement the actions for damages provided by §§11 and 12. See Landis, Liability Sections of Securities Act, 18 Am. Acct. 330, 331 (1933); Douglas and Bates, Federal Securities Act of 1933, 43 Yale L. J. 171, 181-82 (1933); 3 Loss, Securities Regulation 1785-86 (1961). When the House Committee Report listed the sections that "define the civil liabilities imposed by the Act" it pointed only to §§11 and 12 and stated that "[t]o impose a greater responsibility [than that provided by §§11 and 12] . . . would unnecessarily restrain the conscientious administration of

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3 Of course, §12(1)'s imposition of a liability almost absolute upon the seller of a security that has not been registered in violation of §5 of the 1933 Act is grounded on distinctive concerns. See 3 Loss, Securities Regulation 1692-96 (1961).

honest business with no compensating advantage to the public." H. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933). Once it had been established, however, that an aggrieved buyer has a private action under §10(b) of the 1934 Act, there seemed little practical point in denying the existence of such an action under §17—with the important proviso that fraud, as distinct from mere negligence, must be alleged. See *Fischman* v. *Raytheon Mfg. Corp.*, 188 F. 2d 783, 787 n. 2 (2 Cir. 1951); *Weber* v. *C. M. P. Corp.*, 242 F. Supp. 321, 322-25 (S. D. N. Y. 1965) (Wyatt, *J.*); *Thiele* v. *Shields*, 131 F. Supp. 416, 419 (S. D. N. Y. 1955) (Kaufman, *J.*); but see *Dack* v. *Shanman*, 227 F. Supp. 26 (S. D. N. Y. 1964). To go further than this, as Professor Loss powerfully argues, Securities Regulation at 1785, would totally undermine the carefully framed limitations imposed on the buyer's right to recover granted by §12(2) of the 1933 Act.

Even if, however, we were to disregard the teaching of Judge Frank in *Fischman* v. *Raytheon Mfg. Corp., supra*, 188 F. 2d at 786, and follow the lead of those Circuits that seem to have discarded the *scienter* requirement in actions for damages under Rule 10b-5,[4] *Ellis* v. *Carter*, 291 F. 2d 270, 274 (9 Cir. 1961); *Royal Air Properties, Inc.* v. *Smith*, 312 F. 2d 210, 212 (9 Cir. 1962); *Kohler* v. *Kohler Co.*, 208 F. Supp. 808, 823 (E. D. Wisc. 1962) (dictum), aff'd, 319 F. 2d 634 (7 Cir. 1962); *Stevens* v. *Vowell*, 343 F. 2d 374 (10 Cir. 1965); *Myzel* v. *Fields*, 386 F. 2d 718 (8 Cir. 1967);

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4 The imposition of liability on Clayton, Crawford and Coates for "beating the gun" does not require any such metamorphosis of Judge Frank's concept of fraud as the majority opinion seeks to perform. The only one of these defendants who came close to a showing of good faith was Coates. But even he did not act on the belief that the second press release had in fact reached the market, see 258 F. Supp. at 288; his defense was rather a belief that the law required him only to await its issuance. While such an erroneous view of the law is pardonable, it is not "good faith" in a legal sense.

we should not impose such expansive liability in a situation, markedly different from those considered in the cases just cited, where to do so would frustrate, not further, the larger goals of the securities laws. While I am not convinced that imposition of liability for damages under Rule 10b-5(2), absent a *scienter* requirement, even limited in the way just proposed, would not go beyond the authority vested in the Commission by §10b to act against "any manipulative or deceptive device or contrivance" and be so inconsistent with the general structure of the statutes as to be impermissible, it is at least clear that the April 12 press release would be the worst possible case for the award of damages for merely negligent misstatement, as distinguished from the kind of recklessness that is equivalent to wilful fraud, see *SEC* v. *Frank*, 388 F. 2d 486, 489 (2 Cir. 1968).

The issue here, however, is the different one of an injunction. Mr. Justice Goldberg noted in *SEC* v. *Capital Gains Research Bureau*, 375 U. S. 180, 193 (1963), that the elements of a cause of action for "fraud" vary "with the nature of the relief sought" and that "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for money damages." See also *Mutual Shares Corp.* v. *Genesco, Inc.*, 384 F. 2d 540, 547 (2 Cir. 1968). It can, indeed, be argued that, even on this basis, Rule 10b-5(2), absent the reading in of a *scienter* requirement, goes beyond the authority granted by §10b of the 1934 Act. However, it cannot be doubted that one of the most important purposes of the securities legislation was to prevent improper information being circulated by the issuer, and I therefore am not disposed to hold that Congress meant to deny a power whose use in appropriate cases can be of such great public benefit and do so little harm to legitimate activity.

B.

However, it does not necessarily follow that this is an appropriate case for granting an injunction as to future press releases. While we have often said that "a cessation of the alleged objectionable activities by the defendant in contemplation of an SEC suit will not defeat the district court's power to grant an injunction restraining continued activity," *SEC* v. *Boren*, 283 F. 2d 312 (2 Cir. 1960), and cases there cited, it is likewise true that an isolated violation, especially in the absence of bad faith, does not *require* such relief. *SEC* v. *Torr*, 87 F. 2d 446 (2 Cir. 1937). Absent much clearer language than is found in the 1934 Act, the entitlement of a plaintiff to an injunction thereunder remains subject to principles of equitable discretion. The Supreme Court made this clear beyond peradventure in the leading case of *Hecht Co.* v. *Bowles*, 321 U. S. 321 (1944). See 3 Loss, Securities Regulation 1975-83 (1961). Here there is no danger of repetition of an unduly gloomy press release like that of April 12. The essence of the SEC's case is that Timmins was a once-in-a-lifetime affair; the company's motive in issuing the release was laudable; and the defect was solely a pardonable one of execution. If Judge Bonsal had denied an injunction on these grounds, I see no basis on which we could properly have reversed him. Instead he acted on the view, erroneous in the court's belief, that no violation of the Rule had occurred and he was thus without power to enjoin, 259 F. Supp. 296. Although I see no reason why we could not affirm nevertheless, I am content to leave it for him to consider whether, although he has power to issue an injunction, there is equity in this portion of the bill. My concurrence in the disposition of the press release issue assumes that such consideration is permitted.

KAUFMAN, *Circuit Judge* (concurring):

I concur in Judge Waterman's reasoned and thorough opinion and in the court's disposition of the instant appeal. I agree with Judge Friendly, however, that we should provide guidance to the District Courts with respect to pending private claims for damages based upon Rule 10(b)(5) arising out of the transactions now before us. And, I concur in as much as Part II of Judge Friendly's opinion as discusses the origins of the rule and the relevance of today's decision —involving only an application by the S. E. C. for an injunction—to private damage actions.

ANDERSON, *Circuit Judge* (concurring):

I concur in Judge Waterman's majority opinion and I concur in the discussion of law set forth in Part II of Judge Friendly's concurring opinion.

HAYS, *Circuit Judge* (concurring in part and dissenting in part):

I concur generally with Judge Waterman in his views as to the proper interpretation of Section 10(b) and Rule 10b-5 and as to the standards which are to be employed in the application of the statute and the rule.

With the exception of Stephens and Fogarty as recipients of stock options, I agree with the majority on the disposition of the cases involving individuals.

I do not agree on the remand of the issue with respect to Stephens and Fogarty as recipients of stock options. It seems to me clear that the injunction sought by the Commission should be granted.

The majority remand the case against the corporate defendant to the district court for a determination as to

whether the April 12 press release was misleading and whether, if so, those responsible for the release used due diligence.

In my opinion the evidence establishes as a matter of law that the press release was misleading. Indeed, if the correct standard is applied, the finding of the trial court requires the conclusion that the press release was misleading:

> "At 7:00 p.m. on April 9, those with knowledge of the drilling results had material information which it was reasonably certain, if disclosed, would have had a substantial impact on the market price of TGS stock."

The evidence in the record in support of this finding is overwhelming.

Assuming arguendo that the corporation cannot be enjoined except on a showing of lack of due diligence, since Fogarty and those who assisted him in the preparation of the press release were aware of the drilling results to which the district court's finding refers, they obviously did not use due diligence in the preparation of the misleading press release.

I would grant the application for an injunction.

MOORE, *Circuit Judge* (dissenting) (with whom Chief Judge Lumbard concurs):

In their opinion, the majority have become so involved in usurping the function of the trial court, in selecting the witnesses they (at variance with the trial court) choose to believe, in forming their own factual conclusions from the evidence (in disregard of Rule 52a), in deciding with, of course, the benefit of the wisdom of hindsight, how they, had they been executives of Texas Gulf Sulphur Company (TGS), would have handled the publicity attendant to the

exploration of the Timmins property, in determining (to their own satisfaction) the motives which prompted each of the individual defendants to buy TGS stock and in becoming mining engineering experts in their own right, that I find it desirable—in fact, essential—to state my opinion as to the fundamental jurisdiction of the Court of Appeals and the issues properly before us. Primarily, our task should be to review errors of law. Conversely, we are not a jury of nine with no requirement of a unanimous verdict.

If the facts are to be reappraised by an appellate court, they should be measured *mutatis mutandis* in accordance with the standard set for himself by an experienced and learned trial judge who stated his approach in a case charging directors with wrongdoing, as follows:

> "The Court has endeavored * * * to judge the transactions in issue in this case by the applicable legal standards but without the benefit of hindsight as to the facts." (Herlands, *D.J., in Marco, etc.* v. *The Bank of New York, etc.*, 272 F. Supp. 636, 639 (S. D. N. Y., 1967).)

More, specifically, the Court in *Marco* said:

> "The Court is asked by plaintiff, in effect, to substitute its judgment for that of the directors with respect to transactions affecting the internal affairs of the corporation in question. * * * As directors they were, of course, required to perform their duties in accordance with the high standards of fidelity, honesty and prudence applicable to fiduciaries." (p. 639)

The Securities and Exchange Commission (referred to as the "SEC" and "Commission"), as an agency of government, has the responsibility of prosecuting persons who,

and corporations which, in its judgment have violated laws which the Congress has enacted for the praiseworthy purpose of protecting the public from securities frauds. However, as such an enforcement agency, where it assumes a plaintiff's role it must bear the evidentiary fair preponderance burden of all litigants and be subject to the rule that the determination of what evidence is "credible" is for the trial judge.

The Issues

The case logically and chronologically can be divided into two parts: (1) the purchase of TGS stock by individual defendants and stock options issued to them between November 12, 1963 and April 9, 1964, and (2) the TGS press release of April 12, 1964. The stock purchases by Clayton, Crawford and Coates on April 16, 1964, are considered later.

(1) In resolving the stock purchase issue, the primary factual inquiry must be concentrated on (a) the nature and extent of the knowledge possessed by, or available to, the purchaser on the date of purchase, and (b) the position of the purchaser in relation to TGS. The primary legal issue in substance is what duty, if any, rested upon the purchasers to disclose the knowledge they possessed at the time of purchase. The Commission argues that there was a failure to disclose material information. The trial court based its opinion largely upon the lack of materiality of such exploration results as were known between November 12, 1963 and April 9, 1964.

(2) Was the TGS press release of April 12, 1964, false, misleading or deceptive within the meaning of Section 10(b) and Rule 10b-5 in the light of TGS' then knowledge and the then existing factual situation.

The Facts

By-passing momentarily the general knowledge possessed by the officers of TGS as to the far-flung nature of the company's operations, its heavy concentration in the sulphur field, its non-engagement in the field of copper mining, the adverse effect which low sulphur prices had had for many years on the company's earnings despite substantial sales and focusing attention solely upon the Timmins property, the participants in that exploration and the knowledge available to them, I find no factual disputes of importance.

On November 8, 1963, TGS, selecting the most promising area of the one-quarter section then controlled by it, referred to as Kidd 55, drilled an exploratory hole, 1⅛ inches in diameter. All the information that was available upon the completion of the drilling, November 12, 1963, was contained in a core (denominated K-55-1) which was visually examined by Dr. Walter Holyk, Chief Geologist for TGS, and by Kenneth H. Darke, a TGS geologist. This core was unusually good in mineral content. The President, Claude O. Stephens, the Executive Vice-President, Charles F. Fogarty, and the Exploration Vice-President, Richard D. Mollison, were notified, and Fogarty and Mollison flew to the drill site.

In order to acquire the other three-quarters of the K-55 segment, further drilling was discontinued except for one hole drilled to produce a barren core and the site was camouflaged. Thus, but for a chemical assay made in December 1963 of contents of this same core, no other knowledge of the nature and possible extent of the area was available during the acquisition program.

Rule 52(a) should be given particular weight where expert testimony must of necessity play an important role. Here the trial court had an opportunity not only to hear

the qualifications of the experts but also from their demeanor and responses to form its opinion as to their credibility. The importance of this opportunity to observe where technical or scientific problems are before the court, as here, has been succinctly stated by the Supreme Court in *Graver Tank & Mfg. Co.* v. *Linde Air Prods. Co.*, 339 U. S. 605 (1950):

> "Like any other issue of fact, final determination requires a balancing of credibility, persuasiveness and weight of evidence. It is to be decided by the trial court and that court's decision, under general principles of appellate review, should not be disturbed unless clearly erroneous. Particularly is this so in a field where so much depends upon familiarity with specific scientific problems and principles not usually contained in the general storehouse of knowledge and experience." (pp. 609-610)
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> * * * * *
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> "It is not for this Court [the Supreme Court] to even essay an independent evaluation of this evidence. This is the function of the trial court. And, as we have heretofore observed, 'To no type of case is this . . . more appropriately applicable than to the one before us, where the evidence is largely the testimony of experts as to which a trial court may be enlightened by scientific demonstrations. * * *' 336 U. S. 271, 274-5." (p. 611)

No more is it for this court to make an independent essay of the evidence or of the core. Wanting the knowledge requisite to making our own appraisal of the significance of the core, we must depend upon the experts. A correct decision in this case may well hang upon their testimony

and its credibility because what these observers knew or should have known between November 12, 1963 and April 9, 1964 is basic to a determination of what, if anything, should have been disclosed or whether it was "material."

For the defendants, Dean Forrester, Dean of the College of Mines of the University of Arizona and Director of the Arizona Bureau of Mines, said that "one hole is evidence of what you encounter only in that hole" and that even after K-55-3 was drilled in April 1964, it was "much more likely that the materials exposed in those two holes will extend for, let's say, two feet outside the limits of the hole than it is likely that it will extend 25 feet or that it will extend 50 feet."

Dr. Park, former Dean of the School of Earth Sciences at Stanford, admitted that K-55-1 was "an interesting one, a good one" but that there was not "any evidence at all for any discussion of extent, from one drill hole." Dr. Lacy, head of the mining department of the University of Arizona, was of the opinion that "There is no basis for making any sort of prediction out from the hole."

Wiles, a consulting mining engineer, conceded that K-55-1 was a remarkable drill hole but that he could not estimate therefrom the probabilities of finding a commercially mineable body of ore, adding that he had had "the misfortune of having found a very attractive first hole and after drilling 52 around it got no more ore." Walkey, the manager of the Kamkotia, a mine some 12 miles distant from the Timmins property, testified that the geological composition of the Kamkotia and TGS areas was similar but that he could neither estimate nor say the chances were good of proving a substantial body of ore as a result of K-55-1.

Even the Commission's experts, Adelstein and Pennebaker, would not estimate what ore, if any, might lie beyond the 1⅛ inch core.

Adelstein:

"I think assay value given for a drill hole, standing by itself without surrounding information, cannot be interpreted by itself as to what it really means."

Pennebaker:

Q. You certainly couldn't compute any tonnage from that single hole, could you? A. No, sir.

Q. Nor could you compute any grade of ore beyond what was in the core itself? A. You are confined to what is in the core, sir.

[This witness did say that it was "inconceivable to expect the ore would quit immediately outside the drill hole, but you have no way of measuring how far it is going to go except the favorable implication of the anomaly."]

From this testimony, the trial court found:

"However, all the experts agreed that one drill core does not establish an ore body, much less a mine. Defendants' experts unanimously concluded that there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body." 238 F. Supp. at 282.

Despite the experts' virtually uncontradicted testimony, despite Rule 52 a) and despite the Supreme Court's statement of the law, the majority choose to reject the trial court's findings as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field by holding that "knowledge of the possibility which surely was more than marginal of the existence of a mine of the vast magnitude indicated by the remarkably rich drill core located rather close to the surface (sug-

gesting mineability by the less expensive open-pit method) within the confines of a large anomaly (suggesting an extensive region of mineralization) might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell or hold."

Indeed, any such conclusions from a first drill core, if so announced by TGS, would undoubtedly have had a substantial effect on the market price of TGS stock and would have immediately brought forth both the wrath of, and injunction papers from, the Commission charging TGS with issuing false, misleading and unsupported statements to boost the price of the stock.

Factually, the premise posed by the majority is "clearly erroneous." There was no knowledge of the existence of a "mine." Even to the majority in their self-assumed fact-finding role, the "mine" was only a more than marginal "possibility." The testimony was unanimous that no estimate of "magnitude" could be made. The "large anomaly" did not suggest "an extensive region of mineralization" and furthermore TGS did not own or control it in any event. Its area was then limited to its one-quarter segment.

The majority read the record as conclusively establishing "that knowledge of the results of the discovery hole, K-55-1, would have been important to a reasonable investor and might have affected the price of the stock." But disclosure of the "results", namely, preliminary visual inspection of the contents, would have violated the Commission's own rules and standards. The Commission has specifically declared (Sch. I, Form 1-A, Reg. A offerings under the 1933 Act):

> "No claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be prop-

> erly classified as 'proven' or 'probable' ore, as defined below. If the work done has not established the existence of proven or probable ore, a statement shall be made that no body of commercial ore is known to exist on the property."

Item 8(A)(b), 1 CCH Fed. Sec. L. Rep. ¶7327.

The Commission has carefully defined the scope of sampling required to justify even estimates, as follows:

> "The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore."

Id., Item 8A(c), 1 CCH Fed. Sec. L. Rep. ¶7327.

Thus under the Commission's own standards, TGS, if it revealed any information during the November 1963-April 1964 period, would have had to announce to the public in substance "TGS has drilled a 1⅛" core on a one-quarter section owned by it in Timmins, Canada. Although the core appears to have excellent mineral content 'no body of commercial ore is known to exist on the property.'" Contrast such a statement with the April 12, 1964 release so criticized by the Commission. Further contrast it with a hypothetical November 1963 press release implicitly suggested by the majority "TGS as a result of drilling on its property in Canada has knowledge of the more than marginal possibility of a mine of magnitude over an extensive region of remarkably rich mineralization."—a statement which under the circumstances and then known facts would have been the height of recklessness.

In fact, the Commission itself indulges in the very speculation it condemns for, after conceding that "the trial court correctly stated that one drill hole does not establish the existence of a commercially mineable mineral deposit," it straightway contends that the information which arose after the drilling of this first and only (for 4½ months) drill hole revealed such "chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" as to require disclosure by insiders desiring to buy TGS securities.

The Commission's position, consistent with its rules and regulations to protect the public from premature announcements which might well arouse speculative fervor are well expressed in its argument before this Court in its brief on appeal in *Securities and Exchange Commission* v. *Great American Industries, Inc., et al.,* 259 F. Supp. 99, S. D. N. Y., 1966, where it said:

> "Neither the Commission, the sellers, nor anyone else knew or could establish the value of the [mining] properties since they had not been explored except in a very preliminary way. No one can prove the value of a largely unexplored mining prospect" (p. 19).

The conservative (and in my opinion proper) approach of the Commission in *Great American* is reflected in its statement that "The ore content of a property is never 'known' until the ore has been completely removed and the minerals separated." This is probably an overstatement because by the time of the TGS April 16, 1964 press release, exploration had advanced to a point where an estimate of the extent of the tonnage might have been rather accurately made. The Commission in that case also stated two truisms (1) that "it is extremely important that all facts relevant

to an estimate of the value of such property be disclosed," and (2) that "the judgment of the 'value' of this property is dependent upon the results of exploratory work • • • •" (*Great American* brief, pp. 22, 23).

On November 12, 1963 drilling of K-55-1 was terminated at 655 feet. The core of the drill hole contained relatively high percentages of copper and zinc and some silver, although the percentages at any given point fluctuated widely. This result undoubtedly "excited the interest" of the TGS exploration team. TGS decided to acquire the surrounding plots in the Kidd 55 area to enable it fully to investigate the anomaly. The attempt to acquire the adjoining properties at reasonable prices (ultimately $52,500) and the strictures on secrecy are customary in the mining industry, especially when dealing with land of a highly uncertain value. After all, TGS had prior experience in exploration where initially promising situations turned out to be "duds." For example, the company had spent some $7,000,000 to purchase an underwater dome off the coast of Texas and an additional $1,000,000 to drill 21 holes before concluding that there was not enough sulphur in the dome to be of commercial interest.

However, until drilling was resumed, nothing further was learned about the ore content of the property other than as revealed in November and December 1963 from the analysis of K-55-1. The trial court's finding as to this fact is unassailable:

> "The most that can be said of the individual defendants' knowledge after the drilling of K-55-1 is that they had 'hopes, perhaps with some reason,' that it would lead to a mine. *James Blackstone Mem. Lib. Ass'n* v. *Gulf, M. & O. R. Co.*, 264 F. 2d 445, 450 (7th Cir. 1959). The results of K-55-1 were too 'remote'

> when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, i.e., to be deemed material." 258 F. Supp. at 283.

This conclusion is amply supported by the record. Kidd 55 was only one of several thousand anomalies (areas where there is unusual variation in the electrical conductivity of rocks) that TGS detected in its aerial exploration of the Canadian shield. Several hundred of these were considered worthy of further study and options on the land around them were acquired. The District Court found that "TGS had previously drilled 65 equally promising anomalies, but most of them had revealed either barren pyrite or graphite, while a few had shown marginal mineral deposits in insufficient quantities to be commercially mined" (258 F. Supp. at 271).

Against this factual background, what position should have been taken by those few officers and employees of TGS after they knew of the core, K-55-1, and the reports thereon made after visual inspection and analysis? There were several choices. Knowing that the nature and extent of this prospect could not be measured until further exploration was conducted and that further exploration had to await additional land acquisition they could have made no announcement as was the case here.

Turning now to the hypothesis of disclosure: As previously stated, any announcement of the discovery of a remarkable mine would have been both false and misleading. The Commission, however, impliedly suggests for affirmative answer the question: "Whether the chances of imminent success, viewed in the light of the magnitude of the potential economic benefit to Texas Gulf" did not require disclosure by insiders of the status of the drilling [then

only the first hole, K-55-1]? In the field of speculation, it would be interesting to know the position the Commission would have taken if TGS had announced that K-55-1 was "one of the most impressive drill holes completed in modern times" and that it "is just beyond your wildest imagination" (SEC Brief, p. 25). It requires no imagination to venture that such announcements might well have had the "wildest" impact on the market price of TGS stock.

Assuming the majority's and the Commission's full disclosure theory, would the facts as then developed have given the buying or selling public the so-called advantages possessed by the insiders? TGS could have announced by November 15, 1963 that it had completed a first exploratory hole, the core of which by visual examination revealed over a length of 599 of 655 feet drilled, an average copper content of 1.15%, zinc 8.64% or, had TGS waited until mid-December, by chemical analysis 1.18% copper, 8.26% zinc and 2.94% ounces of silver per ton; that TGS would try to acquire the other three-quarters of the segment unless the announcement boosted prices to unwarranted heights; that if the property could be acquired further exploratory holes would be drilled to ascertain the nature and extent, if any, of the ore body; that reports of developments would be made from time to time but that the SEC had indicated that TGS should advise its stockholders and the public that there was no proof as yet that a body of commercial ore exists on the property. Such an announcement would, of course, have been of no value to anyone except possibly a few graduates of Institutes of Technology and they, as the expert witnesses here, would have recognized that one drill hole does not reveal a commercially profitable mine.

The final question to be answered is: were these officers and employees disqualified as the result of possessing information gleaned by the first drill core from purchasing

TGS stock? The number of possibilities for Congressional legislation and Commission rulings are legion. They extend over a gamut between definite extremes. At one extreme is a rule that no officer or employee or any member of their families shall own stock of the company for which they work or purchase stock if he possesses "material" inside information. This assumption raises the question of what is material and who is to make such a determination. Materiality must depend upon the facts and their resolution is for the fact-finder, court or jury. The majority state that the K-55-1 drilling results were material because they "might well have affected the price of TGS stock." But such a statement could be made of almost any fact related to TGS. If a labor strike had kept its plants idle for months, encouraging news of a possible settlement hoped for by the TGS labor negotiators might cause the negotiators to buy. Their belief that the strike would be protracted might cause them to sell. Either announcement might well have affected the market and would to those who bought or sold have seemed misleading and deceptive if the anticipated event did not come to pass. Yet the requirement of hourly bulletins to the press from the conference room would not be compatible with common sense. Scores of day by day intra-company situations come to mind which in the individual opinions of company officers or employees might well affect the price of TGS stock, each individual reacting according to his own judgment. However, companies listed on a national exchange can scarcely broadcast to the nation on a daily basis their hopes and/or expectations from the developments in, for example, their research departments. An even more striking illustration would be found within the structure of a large pharmaceutical company where discoveries of panaceas to cure human disease occupies the workdays of thousands of scien-

tists. Premature announcements of important discoveries would be branded as false and misleading if unfulfilled and all stock purchases made during the course of the research, if ultimately successful would be said to have been made with the advantage of inside information. At the other extreme is an equally easy-to-resolve *Cady, Roberts*[1] situation where a definite fact (the reduction of the dividend) was known by an insider, who participated in the meeting where the decision had already been made, whose knowledge of the probable reaction of the market to such an announcement, namely, a substantial sell-off, caused him to leave the meeting ahead of everyone else and before the potential buyers learned of the bad news to foist his selling orders on the market and his stock on uninformed purchasers. Between these extremes there should be a rule of reason.

Faced with this problem, the trial court selected a period from November 12, 1963 (the first information) to some date after drilling was resumed when it might reasonably be said that a body of commercially mineable ore *might* exist. The trial court, accepting the Commission's experts' version, fixed 7:00 p.m. on April 9, 1964 as the time when TGS had material information which "if disclosed, would have had a substantial impact on the market price of TGS stock" but also found that "the drilling results up to 7:00 p.m. on April 9th did not provide such material information." These findings are clearly supported by the proof upon which the court relied.

Practically all TGS stock in question here was purchased between November 12, 1963 and April 8, 1964. What were the motives behind each of the purchases? Obviously, a subjective approach presents difficulties. A myriad of reasons would be given—hope that a commercially profitable

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1 *In re Cady, Roberts & Co.*, 40 SEC 907 (1961).

mine would be found if further exploration proved the ore to be as promising as the core of K-55-1 (November 12, 1963); the development of a phosphate project and potash mine (November 15, 1963); the prediction of security analysts that there would be a turnabout in the price of sulphur stocks; the acquisition of Canadian oil properties (December 16, 1963); the new high level of free world sulphur use and output (December 30, 1963); the launching of the world's largest liquid sulphur tanker (December 30, 1963); the entry into service of a large liquid sulphur tanker for domestic shipments (January 18, 1964); the sulphur expansion program in Canada (February 8, 1964); the new four-year high in sales reached in 1963 (February 20, 1964); and the $2 per ton price increase for sulphur (April 1, 1964).

There can be little doubt but that those familiar with the results of K-55-1 were influenced thereby in making their purchases. The conclusion of the majority is based primarily on this assumption. They call it "a major factor in determining whether the K-55-1 discovery was a material fact" and say that this "virtually compels the inference that the insiders were influenced by the drilling results." To them, completely disregarding the trial court's findings and substituting themselves as a jury, these purchases are "the only truly objective evidence of the materiality of the K-55-1 discovery." In so holding, they confuse the inducing motive of the individual purchaser with knowledge of material facts which ought to be revealed to the public at large. The inconsistency of the majority's position is immediately apparent. Those who purchased were apparently willing on the basis of the inconclusive first hole and other information to risk a certain amount of their funds in TGS stock, hopeful that

future developments would be favorable. Their motive for purchase does not establish the materiality of the facts which influenced them. However, the importance of this case to the corporate and financial community centers around the news release, its timing and its content. It is unfortunate that the atmosphere surrounding this important issue has been so colored and in the collective mind of the majority so contaminated by the comparatively insignificant stock purchase issue.

The resolution, if such be possible, of the many problems presented in this field should be by rule, as definite as possible, formulated in the light of reality and not retroactive in effect as here. I understand that the Commission has conducted, or is conducting, hearings to enable it to learn the views of the many persons and corporations affected. Presumably the Commission will make recommendations to the Congress to give that body an opportunity to accept or reject after thoughtful debate such proposals as may be made. The companies, the securities of which are listed on exchanges, their employees and investing public alike should have some knowledge of the rules which will govern their actions. They should not be forced, despite an exercise of the best judgment, to act at their peril or refrain *in terrorem* from acting. As to a waiting period after the information regarded as "material" has been disclosed, any such time period should be specifically fixed by Congressional or Commission rule not retroactive in application. There is no proof here that the purchases of the defendants, even if motivated by hopes not then solidly grounded, raised or lowered the market or were manipulative, misleading, deceptive or were accomplished by false or fraudulent devices. The trial court after hearing and seeing the witnesses has resolved these factual issues and in my opinion its decision should be sustained.

Stock Options

On February 20, 1964 the stock option committee, which was not informed of the developments at Kidd 55, granted options to Stephens, Fogarty, Mollison, Holyk, Kline and a number of other top officers of TGS. Since only K-55-1 had been drilled at that point, the District Court correctly held that there was no duty of disclosure on the part of those receiving the options. Assuming *arguendo* that the information was material, those not in top management have no duty to disclose to the directors information already reported to their own superiors since they may reasonably assume that the information has been conveyed to the directors on the stock option committee. The District Court held that Holyk, Mollison and Kline were not in top management and that Kline was ignorant of the details of the drilling results, so as to them no violation of 10b-5 had been made out. The majority disagree as to Kline, placing him in top management along with Stephens and Fogarty, and holding that he had sufficient knowledge that his nondisclosure violated Rule 10b-5. Since the majority admit that Kline "knew only that a hole containing favorable bodies of copper and zinc ore had been drilled in Timmins," it seems clear that he did not possess material information that had to be disclosed. That being the case, I find it unnecessary to decide whether or not Kline was in "top management."

As to Stephens and Fogarty, the majority decision places insider recipients of stock options in a difficult dilemma. Under the majority's decision, an insider must perform the uncommon act of refusing such an option, promoting speculation as to the reasons therefor, or accept the option and face possible 10b-5 liability. The objective of protecting a corporation from selling securities to insiders at a

price below their true worth is fully served by requiring nondisclosing insiders to abstain, not from accepting the stock options, but merely from exercising them—an event likely to occur after the inside information has become public. In any case, the failure to exercise an option is less likely to suggest that the insider possessed material information than the failure to accept such an option. Since the option granted to Kline had not been exercised prior to its ratification by the Texas Gulf directors on July 15, 1965, after full disclosure, there can be no 10b-5 violation as to him, and rescission of the option he received should not be ordered. As Stephens and Fogarty have surrendered the options and the corporation has canceled them, there has certainly been no violation of 10b-5 by them with respect to those options.

The April 12, 1964 Press Release

The majority suggest with, in my opinion, most remarkable business naivete that, instead of the April 12, 1964 press release which the trial court had found as a matter of fact had been issued in the exercise of "reasonable business judgment under the circumstances," in their 1968 judgment "it would have obviously been better to have specifically described the known drilling progress as of April 10th by stating the basic facts." They also suggest that "[s]uch an explicit disclosure would have permitted the investing public to evaluate the 'prospect' of a mine at Timmins without having to read between the lines to understand that preliminary indications were favorable—in itself an understatement." Had TGS followed this *ex post facto* directive, it first would have had to find some news medium capable of reaching the nation's potential investing public and willing to publish a mass of metallurgical reports disclosing

the "basic facts." Any such procedure would have invited the initial question on cross-examination of TGS officials: How could any such "explicit disclosure" have permitted the investing public to evaluate the prospect of a mine, without the necessity of transmitting it for expert opinion to some School of Mines? Of course there would be but one answer: It could not.

The facts as established between the date of the resumption of drilling and the drafting of the release are as follows:

On March 31, 1964 TGS moved four drill rigs onto the property, and by April 10th all were in operation. On Friday morning, April 10th, Mollison and Holyk visited the property and learned the results of the drilling up to that time. Mollison left for New York that evening, arriving on Saturday morning. Holyk left for New York Saturday morning and arrived that same day. Until Saturday morning TGS did not intend to issue a press release on the progress of the exploration.

Despite rumors in the Canadian press that TGS had made a major discovery, Lamont had advised Stephens "that TGS should take no action unless the rumors reached the New York press or until TGS had sufficient information available to issue an appropriate press release." 258 F. Supp. at 293. On Saturday morning, April 11th, both the New York Herald Tribune and the New York Times prominently reported a major ore discovery. In a front page article carrying the title "Canada's Copper Rush" the Herald Tribune stated "The biggest ore strike since gold was discovered more than 60 years ago in Canada has stampeded speculators to the snowbound old mining city of Timmins . . . ." The article also stated that the richness of the copper was so great that the core was flown out of the

country to be assayed and that four more drill rigs were scheduled to start working the following week. All of these statements were inaccurate and a matter of concern to Fogarty and Stephens.[2] Stephens advised Fogarty that TGS should issue a press release to clarify the rumors that Fogarty therefore contacted Mollison who had just returned from Timmins.

Mollison had been advised by Holyk as to the drilling results up to 7:00 p.m. on April 10th. On the basis of this information he, as an experienced mining engineer, did not feel that there was sufficient information to draw conclusions as to size and grade of ore, and he advised Fogarty accordingly.

The District Court held:

> "In seeking the advice of Mollison, the head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances." 258 F. Supp. at 296.

The press release was drawn up with the aid of the above-mentioned persons on Saturday and Sunday morning, and was delivered to the press on Sunday for publication in the Monday papers. It stated in part:

> "Recent drilling on one ore property near Timmins has led to preliminary indications that more drilling

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2 The New York Stock Exchange Company Manual provides:

"Dealing with Rumors Affecting the Market: Occasions may also arise when rumors have been circulated which have no basis in fact or which require clarification or interpretation and which also result in unusual activity or price changes in a particular security. Under such circumstances, the most effective procedure is the quick and speedy denial of such rumors through a release to the public Press . . ."

would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

The majority offer suggestions for improving the press release, but, as their editorial skills and present appraisal of the then mining situation were not available when it was drafted, the relevant issue is whether the District Court was in error in determining that the release was accurate and not misleading.

By 7:00 p.m., April 10, the following data was available:

1. geologists' logs of visual estimate and chemical assay of the results of K-55-1,
2. preliminary estimates of 757 feet of K-55-3 and unrecorded visual estimates of 569 feet of K-55-6, both drilled on the same line as K-55-1 (2400 S),
3. unrecorded visual appraisals of 476 feet of K-55-4, drilled 200 feet to the south of K-55-1, and
4. unrecorded visual appraisals of only 97 feet of K-55-5, drilled 200 feet to the north of K-55-1.

The Commission's experts testified that because copper and zinc had been found in these five holes (although in vary-

ing percentages) it could reasonably be concluded that the mineralization was continuous between holes 400 feet apart and also 100 feet beyond in each direction and to a depth of 600 feet, one hundred feet below the deepest hole. However, the District Court found that:

> "TGS's experts were unanimously of the opinion that at 7:00 p.m. on April 10 the Kidd 55 segment was still a prospect and that no estimates as to proven or probable ore could be made. They all agreed that the April 12 press release accurately set forth the situation as it was known at the time. None thought that TGS could have estimated proven ore, and the Commission's expert, Pennebaker, agreed that this was a matter on which there could be differences of opinion. Defendants' experts testified that on the basis of the drilling to that time there was no assurance of continuity in the mineralized zone and that, without further drilling, the results of one hole could not be correlated with the results of others." 258 F. Supp. at 295.

The April 12 release therefore correctly described Kidd 55 as a "prospect." While that term is a word of art in the mining trade used to describe "a property where there is no assurance, from the information known, that a commercially mineable ore body exists" [Pennebaker], its technical definition is no different from the definition in common use. See Webster's New International Dictionary (2d ed. unabridged 1960). Nor is there any inconsistency between the release and the District Court finding that as of April 9, 1964 "there was real evidence that a body of commercially mineable ore *might* exist." 258 F. Supp. at 282 (emphasis added). The District Court characterized the press release as an accurate portrayal of the situation as it was known

at that time. The inference is therefore inescapable that the Court felt that a reasonable investor would not be misled by it. The Commission's whole argument appears to be that the release should have been more optimistic (if conclusions were to be used at all), and that it should have referred to Kidd 55 as having "proven" or "probable" ore. But such a press release would have been highly misleading since the information necessary to draw such conclusions was not available on April 10—according to the TGS witnesses whom the District Court chose to believe.

As evidence that the April 12 release was probably inaccurate, the majority point to the fact that only three days later TGS prepared the April 16 release which announced a major mineral discovery. However, this release was based on more information of significance than was available on April 10 at 7:00 p.m. Between April 12 and April 15 five additional holes had been drilled, K-55-5, 6, 7, 8 and 10 and by April 15 at 7:00 p.m. 5198 feet of core had been drilled compared with 2776 feet on April 10. Furthermore, the location of drilling holes is critical in determining continuity. Most of the footage drilled by April 10 had been in a single plane (2400 S), but by April 15 drilling had established mineralization in a number of additional planes. There is therefore no inconsistency in the statements made and the conclusions reached in the two releases.

The majority remand for a determination of the effect of the April 12 release on a reasonable investor because in its opinion "the effect of this release on the investing public was equivocal and less than abundant." The evidence of the actual effect of the release on investors was at best inconclusive. The Commission offered no proof that anyone was misled by the release—e.g. testimony tending to show that most investors thought the release meant that TGS had no hopes of making an ore discovery. Those

that had been advised by the broker Roche to purchase stock did not sell upon reading the April 12 release. Several brokers testified that they interpreted the release as affirmative and encouraging. The market opened at 30⅛ on the 13th (when the release became public) and closed at 30⅞—scarcely a sign of public pessimism. The next day the market closed at 30¼. The District Court correctly found that "the issuance of the release produced no unusual market action." 258 F. Supp. at 294. Nor did he find the release to be "gloomy." His statement was that: "While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known." 258 F. Supp. at 296. With the aid of hindsight the release may indeed seem gloomy, but that is because it is now known that a very substantial tonnage of ore exists. Hindsight, however, is not the test. Furthermore, even if some investors considered the release to be discouraging compared to the rumors afloat, if the facts and conclusions presented were accurate (as they were) and if they were not presented in a manner that would mislead a reasonable investor (which they were not) then there can be no violation of 10b-5.

The District Court aptly pointed out that in quelling the rumors TGS had to proceed with caution:

> "If they said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that their press release was misleading or deceptive—and, indeed, this is what has happened." 258 F. Supp. at 296.

While it thus might have been "safer" for TGS to have issued a sheaf of drilling results and mineral analyses

(which the press would probably have declined to print), "they would have [thereby] encouraged the rumor mill which they were seeking to allay." *(Ibid.)* Stephens and Fogarty decided that the best course was to give their evaluation of the situation—a reasonable business judgment that should not incur 10b-5 liability unless their evaluation was either false or misleading. The experts which the trial court credited were of the opinion that Kidd 55 was accurately portrayed as a prospect which required further exploration. The trial court found that the release was not "misleading or deceptive on the basis of the facts then known," and the majority state that from the record they cannot "definitively conclude that it was deceptive or misleading to the reasonable investor." It would therefore appear that the Commission has failed in its burden of proof, unless it can be said that TGS was negligent in not obtaining later data from Timmins before issuing the release.[3]

Of necessity the April 12 press release had to be issued on the basis of the drilling results through 7:00 p.m., April 10, and it seems clear that the trial court determined that it would not be reasonable to charge TGS with knowledge of later information. While additional drilling was done on Saturday and Sunday, April 11 and 12, the cores had not been seen by the geologists advising management, and there was no way of communicating with the drill site even if someone had been available there to give a reliable appraisal. Mollison and Holyk were in New York for the weekend, and there was no telephone at the site—the only way to communicate with the site was to go there. The decision to issue a press release was not made until Satur-

3 Of course, even if TGS were negligent in not obtaining later data, a determination must still be made that the press release was misleading in light of this later information.

day, at which point Fogarty testified it "would just be very difficult for us to try to find anyone in Timmins." The statement was released Sunday afternoon and Mollison and Holyk were asked "to return to Timmins as promptly as possible and to move things along." It therefore cannot be said that TGS was negligent in not obtaining more current data, and it is certainly not negligent simply because it decided to issue the statement when it did. A remand on this point is therefore not justified.

The "in connection with" Clause Precludes the Imposition of §10(b) Liability on TGS.

In any event, the Commission still has the problem of showing that the other requirement of the statute and rule is met, namely that the release was issued "in connection with" a securities transaction on the part of TGS. This requirement is explicit in §10(b) of the Act (15 U. S. C. §78j) which provides:

> It shall be unlawful for any person . . .
>
> (b) To use, or employ, *in connection with the purchase or sale of any security* registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Pursuant to this authority the Commission in 1942 promulgated Rule 10b-5 (17 C. F. R. §240.10b-5) which states:

> Employment of Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, *in connection with the purchase or sale of any security.*

In determining whether the requisite "connection" to a securities transaction was present in this case, the District Court found:

> "From the foregoing, it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action. In the absence of a showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders, the issuance of the press release did not constitute a violation of Section 10(b) or Rule 10b-5 since it was not issued 'in connection with the purchase or sale of any security.'" 258 F. Supp. at 294.

The District Court held that if TGS or its insiders had purchased TGS stock after issuing the allegedly misleading press release, the inference could be drawn that it was issued to reduce the price of the stock to facilitate purchases at bargain prices. Such a deceptive or manipulative

practice would be prohibited by 10(b) and Rule 10b-5. See *Gann* v. *BernzOmatic*, 262 F. Supp. 301 (SDNY 1966); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239 (SDNY 1962). Moreover, noting that the "in connection" clause has been broadly construed, the District Court did not require that stock purchases by TGS or insiders be shown. Instead, the court held that "the issuance of a false and misleading press release may constitute a violation of Section 10(b) and Rule 10b-5 if its purpose is to affect the market price of the company's stock to the advantage of the company or its insiders. *Freed* v. *Szabo Food Serv., Inc.*, CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964)." 258 F. Supp. at 293. Thus, even if TGS or its insiders had not engaged in securities transactions, if there were evidence from which it could be inferred that the press release was intentionally issued to depress the price of the stock as part of some fraudulent scheme, a 10b-5 violation would have been stated.[4] But in this case the only purpose of the press release was to quell the extravagant rumors circulating about the Canadian exploration project. No facts whatsoever were adduced which would have justified a finding that the release was issued for a fraudulent or manipulative purpose. To hold that such a statement incurs 10b-5 liability is contrary to the intent of Congress in passing §10(b) and settled judicial construction. Furthermore, such a holding might well have the unfortunate result of deterring the dissemination of corporate news despite the strong policy underlying all securities legislation of encouraging disclosure of information useful to present and potential investors. If press releases have to read like prospectuses to guard against possible 10b-5 liability, it is safe to predict that they will quickly fall out of favor with corporate management.

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4 Whether the release had any such effect would, of course, be irrelevant.

The Commission advances the argument (successful with the majority) that the "in connection" requirement is satisfied by the mere fact that the public is purchasing and selling securities on the open market. Thus any statement issued by a publicly listed company is made "in connection" with the purchase or sale of securities. The majority approve of this interpretation because "the investing public may be injured as much by one's misleading statement containing inaccuracies caused by negligence as by a misleading statement published intentionally to further a wrongful purpose." However, the fact remains that §10(b) of the Securities Exchange Act was not passed to protect investors from the former type of injury, but leaves liability for such misrepresentation up to state law, which is well equipped to handle any such situation. See, e.g., Note, Accountant's Liabilities for False and Misleading Statements, 67 Colum. L. Rev. 1437 (1967). Section 10(b) was certainly not intended to be a mandate to the Commission to erect a comprehensive regulatory system policing all corporate publicity, as the majority now contend. The legislative history clearly reveals that the statute was passed to prohibit deceptive and manipulative devices used in connection with securities transactions, and that the "connection" between the complained of conduct and the securities transactions must be a closer one than the majority now sanctions. See S. Rep. No. 792, 73rd Cong., 2d Sess. (1934); H. R. Rep. No. 1383, 73rd Cong., 2d Sess. (1934); S. Rep. No. 1455, 73rd Cong., 2d Sess. (1934); Comment, 74 Yale L. J. 658, 681-82 (1965).

The broad congressional purpose in passing the Securities Exchange Act of 1934 is set forth by Thomas G. Corcoran, one of the draftsmen of the bill that became the 1934 Act. He stated at a 1934 House hearing that "this bill has

at bottom five ideas in it, and all 36 pages tie in around the five ideas." According to Corcoran these five ideas were (1) control on the amount of credit, (2) control of manipulations, (3) control of insider trading [§16(b)], (4) elimination of abuses in the market machinery, and (5) the establishment of the Securities Exchange Commission to administer the Act. As to manipulation, he testified that:

> "As I will point out later, there are only a very few real battlegrounds in this act. Manipulation is not one of them. The provisions of this bill, as to manipulations upon stock exchanges, are agreed to practically everywhere. . . . Matched orders, washed sales, pools, options —all of the rest of them are out. So, control of manipulative practices is really not something your committee has to thrash out around this table." [5]

It is therefore not surprising that there is little discussion in the legislative history as to the meaning of the language in the anti-manipulation provisions. It was obviously thought that sections outlawing devices that had been shown at great length to be deleterious did not require any lengthy explication. This is unfortunate because it has resulted in §10(b) being given a construction and significance which, in my opinion, Congress did not foresee and did not intend.

This conclusion is fortified by the provisions of the Act dealing with manipulation since the more specific prohibitions make it clear what evils Congress intended to eradicate by §10(b). Section 9, 15 U. S. C. §78i provides that it shall be unlawful for any broker, dealer or other person to create a false or misleading appearance of activity in the

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5 Hearings before the House Committee on Interstate and Foreign Commerce on H. R. 7852 and H. R. 8720, 73rd Cong., 2d Sess. (1934).

market for a stock or to attempt to affect the price of a stock by certain specific manipulative devices.

Section 10(a), 15 U. S. C. §78j provides:

> Manipulative and Deceptive Devices
>
> It shall be unlawful for any person . . .
>
> (a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Read in context it seems clear that §10(b) was only meant to be a supplement to the specific prohibitions contained in §9 and §10(a). Commenting on the section that became §10(b), Corcoran stated:

> "Subsection [b] says, 'Thou shalt not devise any other cunning devices.' . . . Of course subsection [b] is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of a clause. The Commission should have the authority to deal with new manipulative devices."

Since the manipulative devices outlawed by §9 all involve fraudulent activities integrally related to securities transactions, the conclusion necessarily follows that the "other cunning devices" sought to be prohibited by §10(b) and Rule 10b-5 are those which also involve securities transactions as an integral part of the fraud. The statute as enacted requires that the fraudulent scheme be "in connection with the purchase or sale of any security." The

expression "in connection" is used elsewhere in the Act, including §9(b), as a shorthand method of indicating that the activity sought to be made illegal is that having a direct relation to securities transactions. The majority read the phrase as merely requiring that the allegedly misleading statement be issued by a publicly traded corporation. They argue that the "connection" that has to exist between a corporate statement and a security transaction is supplied by the theoretical argument that every "material" corporate statement presumably affects the market price of the issuer's securities. In my opinion such a broad interpretation of the statute is unwarranted as a matter of statutory construction and unwise as a matter of policy.

Congress has made it clear in the other antifraud provisions of general application that its concern was not with allegedly misleading corporate publicity but rather with purposeful schemes to deceive and defraud the public by means of manipulative and deceptive devices which directly involve purchases or sales of securities. Thus §12(a), 15 U. S. C. §77*l* of the 1933 Act provides that any person who "offers or sells a security" by means of a prospectus or oral communication which includes a misstatement or omission of a material fact shall be civilly liable. Similarly §17(a) of the 1933 Act, 15 U. S. C. §77q(a), provides that it "shall be unlawful for any person in the offer or sale of any securities" to engage in fraudulent activity.

A further insight into the proper scope of 10b-5 can be gained by examining §17(a), 15 U. S. C. §77g(a) which is almost word for word the same except for the explicit requirement that any alleged fraud be associated with "the offer or sale of . . . securities." The only difference of substance between §17(a) and Rule 10b-5 is that the latter applies to purchasers as well as sellers. *Ellis* v. *Carter*,

291 F. 2d 270, 272-274 (9th Cir. 1961); SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942) ("The new rule closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase."); Milton Cohen, "Truth in Securities Revisited," 79 Harv. L. Rev. 1340, 1364 (1966).

Finally, §15(c)(1), (2), 15 U. S. C. §78o(c)(1), (2) provides that no broker or dealer shall (1) induce the purchase or sale of any security by means of any manipulative, deceptive or other fraudulent contrivance or (2) attempt to induce the purchase or sale of any security "in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice . . . ."

The majority argue that when compared with the above provisions the slight change of wording in §10(b)—the insertion of the phrase "in connection with . . . "—indicates that Congress intended a revolutionary change in the whole thrust of the securities laws. That is too slim a basis to support a judicial excursion over such uncharted seas. It is most doubtful that Congress intended such a result, and the merits of such a change are so unexplored that Congress should certainly be consulted before making it.

The majority support their action in part by a long quotation from H. R. Rep. No. 1383. It should be noted that the discussion at that point of the report is not addressed to §10(b) but to the reporting and disclosure provisions of Securities Exchange Act of 1934, specifically §§12-14, 16. Section 12 of the Act, 15 U. S. C. §78*l*, requires the registration of securities traded on a stock exchange and of certain other widely held securities. Detailed information similar to that required by the 1933 Act has to be filed with the Commission for such registered securities, and this infor-

mation is required by §13, 15 U. S. C. §78m, to be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges. In addition §16(a), 15 U. S. C. §78p(a), requires certain officers, directors and major shareholders to file reports with the Commission and the stock exchanges as to their initial holdings of stock and subsequent changes. Finally, pursuant to §14, 15 U. S. C. §78n, the Commission has promulgated proxy rules setting forth information that must be sent to shareholders prior to their annual or other meetings. See Schedules 14A-14C, 17 C. F. R. §240.14a-101–103.

To encourage compliance with these disclosure and reporting requirements, Congress enacted civil (§18, 15 U. S. C. §78r) and criminal (§32, 15 U. S. C. §78ff) provisions. A close reading of §18 will demonstrate that a plaintiff proceeding under that section (as opposed to §10(b)) does not have to show that the misleading statement was issued by a person [or corporation] who engaged or participated in a securities transaction or even that the misstatement was intended to influence securities transactions as part of some fraudulent scheme. Therefore, the statements in the legislative history applicable to the reporting and disclosure provisions have no bearing on the correct interpretation of §10(b). That section was not meant to be an auxiliary disclosure device or a provision to punish those who issue inaccurate statements in newspapers or documents filed with the Commission *unless* they are fraudulent acts integrally connected with securities transactions. If there is no such connection, investors are relegated to §18 or state law to recover their losses and the Commission must use its other remedies, discussed *infra*.

In discussing Rule 10b-5 Cohen expressed concern which, as a result of the majority opinion, seems to have been well

founded, that Rule 10b-5 would be given an "unwarranted" extension. In "Truth in Securities Revisited," *op. cit. supra,* at 1366, he said:

> "Nor is it clear that Rule 10b-5 will not be read as providing an alternative remedy (alternative to the considerably more limited express remedy of section 18) for false or misleading statements in filing under sections 12 and 13. One might regard these as surprising and even unwarranted extensions of Congress's terse proscription of 'any manipulative or deceptive device or contrivance' in section 10(b) and yet not care to predict confidently that the momentum of decisions will not carry this far."
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> " . . . I firmly believe that whatever inadequacy is found in §18, as the basic civil liability provision applicable to the continuous disclosure system, ought to be taken care of by direct amendment of the section itself, not by resorting to the broader, vaguer, but (in my view) otherwise directed provisions of Rule 10b-5. I believe that the problem of misrepresentation in a registrant's (issuer's) required filings is quite distinct from the problem of fraud or misrepresentation by a purchaser or seller of a security (even though the two areas sometimes overlap), and that more mischief than good is likely to come from confusing them or treating them as interchangeable."
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> (Cohen, *op. cit. supra* at 1370, n. 89)

The majority opinion must also be considered in light of its overall impact before a decision can be reached as to its advisability (assuming that the power to interpret §10(b) is as unlimited as the majority apparently believe).

It should be realized that the construction given 10b-5 will turn it into a comprehensive regulatory provision applicable to all corporate and individual statements, but without any of the detailed standards necessary to implement such a program. The Commission is presently arguing that 10b-5 is applicable to all corporate statements disseminated to the public or filed with the Commission. See *S. E. C.* v. *Great American Industries, Inc.*, 259 F. Supp. 99 (S. D. N. Y. 1966), appeal pending; *Heit* v. *Weitzen*, 260 F. Supp. 598 (S. D. N. Y. 1966), *Howard* v. *Levine*, 262 F. Supp. 643 (S. D. N. Y. 1965), consolidated appeal pending sub nom. *Heit* v. *Weitzen* (*amicus curiae*). The majority opinion appears to approve of the Commission's position without reservation.

The Commission's arsenal of weapons for fighting misleading statements has certainly not been shown to be insufficient for it to carry out the tasks that Congress assigned to it. Rule 10b-5 remains a potent method of proceeding against fraudulent schemes which involve securities transactions for both the Commission and private investors. The Commission can also obtain injunctions to enforce compliance with the disclosure and other provisions of the Securities Exchange Act (§21, 15 U. S. C. §78u), and stiff criminal penalties are provided for failure to comply with the statute or rules promulgated thereunder (§32, U. S. C. §78ff). The Commission can suspend trading for successive periods of 10 days in any security which it feels is being affected by misleading press releases (§§15(c)(5), 19(a)(4), 15 U. S. C. §§78o(c)(5), 78s(a)(4)). For an example of the effective use of this latter power see SEC Sec. Exch. Act Rel. No. 7741 (Nov. 4, 1965) relating to suspension in trading of Belock Instrument Corporation, a defendant in *Heit* v. *Weitzen, supra.* Finally, when faced

with the repeated issuance of misleading press releases, the courts can without more proof draw the inference that they were purposefully distributed to affect the price of the issuer's securities, justifying injunctive relief under 10b-5 and possibly other remedies. See *SEC* v. *Electrogen Industries, Inc.*, 68 Civ. 23 (EDNY, Feb. 26, 1968). In any event if the Commission feels that its arsenal should be augmented, Congress not the courts is the proper forum for its arguments.

Other Judicial Interpretation

The construction given the "in connection" clause by the District Court has been followed in the many cases that have considered the point. See *SEC* v. *North American Research & Development Corp.*, 1968 CCH Fed. Sec. L. Rep. ¶92,149 (SDNY Feb. 8, 1968); *Puharich* v. *Borders Electronics Co., Inc.*, 1968 Fed. Sec. L. Rep. ¶92,141 (SDNY Jan. 24, 1968); *Howard* v. *Levine*, 262 F. Supp. 643 (SDNY 1965), appeal pending; *Gann* v. *BernzOmatic*, 262 F. Supp. 301 (SDNY 1966) (dictum); *Heit* v. *Weitzen*, 260 F. Supp. 598 (SDNY 1966), appeal pending.

It is of course true, as the Commission points out, that the "in connection" clause has been given a broad construction by the courts in line with the remedial nature of securities legislation (see *SEC* v. *Capital Gains Bureau*, 375 U. S. 180, 195 (1965); cf. *Tcherepnin* v. *Knight*, 389 U. S. 332, 336 (1967)), but no case supports the Commission's position that it is in effect meaningless. The cases to date have involved defendants who if not actually purchasing or selling securities at least participated in a direct manner in a securities fraud.[6] Thus one who conspires with or aids and abets another in the fraudulent purchase or sale

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6 In two cases, on motions to dismiss, two courts have permitted 10b-5 actions to continue where defendants were not alleged to be intimately

of securities may have the needed connection. See *Pettit* v. *American Stock Exchange*, 217 F. Supp. 21 (SDNY 1963) (Defendant Exchange and its officers allegedly aided and abetted an illegal distribution of stock by its failure to take necessary disciplinary actions against abusive conduct and practices of its employees of which they knew or should have known. Held: sufficient allegation of fraud under 10b-5); *Brennan* v. *Midwestern United Life Ins. Co.*, 259 F. Supp. 673 (N. D. Indiana 1966) (Defendant corporation allegedly aided and abetted an alleged violation of 10b-5 by its brokerage firm because of its failure to report the improper activities of said firm to the proper authorities. Held: cause of action stated under 10b-5).

Similarly, corporate officers or directors may be liable for causing their corporation to engage in securities transactions. See *Ruckle* v. *Roto American Corp.*, 339 F. 2d 24 (2d Cir. 1964) (Corporation allegedly defrauded into issuing securities to its President through the failure or refusal of some of its directors fully to disclose to the remaining directors material facts concerning the transactions or the financial condition of the company); *Bredehoeft* v. *Cornell*, 260 F. Supp. 557 (D. Ore. 1966) (Plaintiff induced to sell his stock to the corporation for less than its true value because the defendants, stockholders and directors of the company fraudulently concealed material facts); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261 (SDNY 1963) (Defendants caused plaintiff corporations, of which they were officers, to issue stock for property which was worth much less than the stock); cf. *H. L. Green Co.* v. *Childree*,

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connected with a purchase or sale of securities. *Miller* v. *Bargain City, U. S. A.*, 229 F. Supp. 33 (E. D. Pa. 1964); *Fischer* v. *Kletz*, 266 F. Supp. 180 (SDNY 1967). But in both cases the courts recognized that further factual and legal development was necessary for the proper resolution of the issue.

185 F. Supp. 95 (SDNY 1960) (Accountants allegedly induced corporation to go through with a merger (a securities transaction) by preparing false financial statements and making other misrepresentations).

A corporation may itself violate Rule 10b-5 if it engages in fraudulent activities in connection with a merger or other transaction involving securities. See *Freed* v. *Szabo Food Service, Inc.*, '61-'64 CCH Fed. Sec. L. Rep. ¶91,317 (N. D. Ill. 1964) (Corporation, as part of a campaign to boost the value of its stock to achieve stockholder approval of a merger, deliberately issued statements misrepresenting future combined earnings. The price went up and the shareholders were impressed with this indication of the opinion of the financial community as to the proposed merger. The plaintiffs were held to have stated a cause of action under 10b-5 because they allegedly bought stock in the combined company on the strength of those misrepresentations.); cf. *Vine* v. *Beneficial Finance Co.*, 374 F. 2d 627 (2d Cir. 1967) (Corporation fraudulently arranged a merger so that one class of shareholders would receive much less than the other class which was comprised of officers and directors. While the alleged fraudulent acts were committed before plaintiff sold his stock (he had not at the time of suit), he was about to be forced to sell his part of a single fraudulent scheme.).

Another series of decisions involve a broker, dealer or financial institution which fraudulently induced plaintiff's purchase or sale. See *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (SDNY 1965) (Plaintiffs retained stock in a company solely because a broker misrepresented or failed to disclose certain material facts.); *Glickman* v. *Schweickart & Co.*, 242 F. Supp. 670 (SDNY 1965) (Broker induced plaintiff to purchase some stock and to finance the purchase through a factor without disclosing material facts concern-

ing the risks of such a procedure.); *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (SDNY 1964) (Trust company alleged to be a participant in a fraudulent scheme whereby loans were made to plaintiff by a factor who converted the stock when it was pledged as collateral for the loan.); *Meisel* v. *North Jersey Trust Co.*, 218 F. Supp. 274 (SDNY 1963) (same); *Lorenz* v. *Watson*, 258 F. Supp. 724 (E. D. Pa. 1966) (Brokerage house liable to plaintiff if it failed to supervise adequately one of its employees who allegedly was guilty of "churning" or excessive turnover in plaintiff's account.). See also §§9(a)(4), 15(c)(1), (2), 15 U. S. C. §§78i(a)(4); 78o(c)(1), (2). In all of the above cases the defendants, unlike the defendant here, were clearly participants in a securities transaction and were guilty of or responsible for deceptive activities of which the securities transaction was an integral part.

The Injunction Remedy

The remedy of a permanent injunction against the company, its offiicers and agents, the issuance of which the majority leaves to the discretion of the trial court, would not only be inappropriate but would be destructive of fundamental rights—"inappropriate" because based upon one "too-gloomy" press release on April 12, 1964, with no proof of continuing gloominess thereafter. The issuance of any injunction over four years after the alleged violation would place a large company and its many executive employees under the possibility, without even a *Miranda* warning, that anything they say may be held against them and place them under the danger of criminal sanctions; "destructive of fundamental rights" because the restraint constitutes not "double" jeopardy but "perpetual" jeopardy. If, as the majority say, the test of the news release is its impact on the "reasonable" investor (although they indicate that the un-

reasonable speculator, too, comes under their solicitous wing) to avoid the danger of injunction violation it would be necessary to seek a declaratory judgment from the courts (both trial and appellate because following the majority, Rule 52(a) would no longer apply). As to the sufficiency of the news release, the first issue would be what constitutes a "reasonable" investor. After the court had made a preliminary finding of reasonableness, these investors could then testify as to the impact that the proposed release would have on them. Query, as to whether twelve witnesses (akin to a jury) should be required—and would a seven-to-five count be acceptable or would ten-to-two more accurately reflect public opinion? Other situations and problems of an equally *reductio ad absurdum* character can easily be conjured up. They would only point more directly to the conclusion that an injunction here would not only violate fundamental legal principles which for centuries have restricted the injunctive grant but would not be justified by any sufficient factual showing in this case. No clear and present danger, no continuing wrongful acts and no likelihood thereof are to be found in the record before this court.

Crawford, Clayton and Coates

Since I believe that the findings of the trial court are solidly founded and should be respected, I agree with its decision as to Crawford and Clayton. I agree with the majority as to Coates because for all practical purposes the information had not become public at the time of his purchase order.

Conclusion

In summary, the most disturbing aspect of the majority opinion is its utterly unrealistic approach to the problem

of the corporate press release. If corporations were literally to follow its implications, every press release would have to have the same SEC clearance as a prospectus. Even this procedure would not suffice if future events should prove the facts to have been over or understated—or too gloomy or optimistic—because the courts will always be ready and available to substitute their judgment for that of the business executives responsible therefor. But vulnerable as the news release may be, what of the many daily developments in the Research and Development departments of giant corporations. When and how are promising results to be disclosed. If they are not disclosed, the corporation is concealing information; if disclosed and hoped-for results do not materialize, there will always be those with the advantage of hindsight to brand them as false or misleading. Nor is it consonant with reality to suggest, as does the majority, that corporate executives may be motivated in accepting employment by the opportunity to make "secret corporate compensation . . . derived at the expense of the uninformed public." Such thoughts can only arise from unfounded speculative imagination. And finally there is the sardonic anomaly that the very members of society which Congress has charged the SEC with protecting, i.e., the stockholders, will be the real victims of its misdirected zeal. May the Future, the Congress or possibly the SEC itself be able to bring some semblance of order by means of workable rules and regulations in this field so that the corporations and their stockholders may not be subjected to countless lawsuits at the whim of every purchaser, seller or potential purchaser who may claim he would have acted or refrained from acting had a news release been more comprehensive, less comprehensive or had it been adequately published in the news media of the 50 States.

APPENDIX A

Judgment of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the thirteenth day of August one thousand nine hundred and sixty-eight.

Present:

Hon. J. EDWARD LUMBARD, Chief Judge,
Hon. STERRY R. WATERMAN,
Hon. LEONARD P. MOORE,
Hon. HENRY J. FRIENDLY,
Hon. J. JOSEPH SMITH,
Hon. IRVING R. KAUFMAN,
Hon. PAUL R. HAYS,
Hon. ROBERT P. ANDERSON,
Hon. WILFRED FEINBERG,
Circuit Judges.

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellant,

v.

TEXAS GULF SULPHUR CO., *et al.*,
Defendants-Appellees,

DAVID M. CRAWFORD and RICHARD H. CLAYTON,
Defendants-Appellants.

Appendix A

Judgment of the United States Court of Appeals for the Second Circuit

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the order and judgment of said District Court be and they hereby are affirmed in part and reversed in part and that the action be and it hereby is remanded to said District Court for further proceedings below consistent with the opinion of this court.

A. Daniel Fusaro
Clerk

By Vincent A. Carlin
Chief Deputy Clerk

Appendix A

Second Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

65 Civ. 1182

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff,

v.

TEXAS GULF SULPHUR COMPANY, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, CLAUDE O. STEPHENS, THOMAS P. O'NEILL, EARLE L. HUNTINGTON and HAROLD B. KLINE,

Defendants.

(6863) BONSAL, D. J.

I. Introduction

This action was instituted by the Securities and Exchange Commission (SEC) pursuant to Sections 21(e) and 27 of the Securities Exchange Act of 1934, 15 U.S.C. §§78u(a) and 78aa (the 1934 Act), against Texas Gulf Sulphur Company (TGS) and several of its officers, directors, and employees. The SEC alleged violations of Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5, promulgated pursuant thereto. The complaint alleged that from November 12, 1963 through April 16, 1964 certain of the defendants had purchased TGS stock or calls or recommended it to others, or acquired stock options, on the basis of material inside in-

formation concerning the results of TGS's exploration activities near Timmins, Ontario, while such information remained undisclosed to the investing public, the Stock Option Committee, and to TGS shareholders who sold during the period, and that on April 12, 1964, TGS issued a false and deceptive press release with respect to these activities.

All parties agreed that the trial should first be had on the issue of whether the defendants or any of them had violated Section 10(b) or Rule 10b-5, reserving for later hearing the issue of the remedy to be applied in the event such violations were found.

The issue of liability was tried by this court and the court's opinion is reported at 258 F.Supp. 262 (S.D.N.Y. 1966). (6864) The Court of Appeals affirmed in part and reversed and remanded in part, 401 F.2d 833 (2d Cir. 1968) *cert. denied,* 394 U.S. 976 (1969), holding that the defendants who purchased TGS stock or calls, or who recommended such purchases to others, or accepted stock options, before the material information as to the Timmins drill results was disclosed had violated Section 10(b) and Rule 10b-5. The Court of Appeals directed that this court reconsider the April 12 press release (the press release) in light of its opinion.

Beginning on October 6, 1969, this court held a hearing to:

(a) receive further evidence regarding the press release and its interpretation by the reasonable investor; and

(b) determine the remedy to be accorded the SEC with respect to the defendants found to have violated Section 10(b) and Rule 10b-5.

The events which led to this litigation are set forth in detail in the opinion of the Court of Appeals, 401 F.2d at 840-41, 843-47, and in the opinion of this court, 258 F.Supp. at 268-75, 293-94.

II. The April 12, 1964 Press Release

On Sunday, April 12, 1964, at about 3:00 P.M., TGS issued the following press release:

(6865) For Immediate Release

TEXAS GULF SULPHUR COMMENT ON
TIMMINS, ONTARIO, EXPLORATION

New York, April 12—The following statement was made today by Dr. Charles F. Fogarty, executive vice president of Texas Gulf Sulphur Company, in regard to the company's drilling operations near Timmins, Ontario, Canada. Dr. Fogarty said:

"During the past few days, the exploration activities of Texas Gulf Sulphur in the area of Timmins, Ontario, have been widely reported in the press, coupled with rumors of a substantial copper discovery there. These reports exaggerate the scale of operations, and mention plans and statistics of size and grade of ore that are without factual basis and have evidently originated by speculation of people not connected with TGS.

"The facts are as follows. TGS has been exploring in the Timmins area for six years as part of its overall search in Canada and elsewhere for various minerals—lead, copper, zinc, etc. During the course of this work, in Timmins as well as in Eastern Canada, TGS has conducted exploration entirely on its own, without the participation by others. Numerous prospects have been investigated by geophysical means and a large number of selected ones have been core-drilled. These cores are sent to the United States for assay and detailed examination as a matter of routine and on advice of expert Canadian legal counsel. No inferences as to grade can be drawn from this procedure.

"Most of the areas drilled in Eastern Canada have revealed either barren pyrite or graphite with-

out value; a (6866) few have resulted in discoveries of small or marginal sulphide ore bodies.

"Recent drilling on one property near Timmins has led to preliminary indications that more drilling would be required for proper evaluation of this prospect. The drilling done to date has not been conclusive, but the statements made by many outside quarters are unreliable and include information and figures that are not available to TGS.

"The work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading. When we have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement to its stockholders and to the public in order to clarify the Timmins project."

Texas Gulf Sulphur, the world's leading sulphur supplier, has conducted a continuing program of exploration for many years all over the world, searching not only for sulphur, but for oil and gas, metallic sulphides, potash, phosphate, trona and other minerals. This program has been successful, resulting in a broad diversification program from essentially a one-product company. In Moab, Utah, TGS has under way a $40 million potash operation which will be the largest in this country and is expected to start operating this year. The company recently announced a $45 million program to develop phosphate reserves at Lee Creek in North Carolina. The company is also drilling extensively for oil and gas in Western Canada and has other activities under way in trona.

April 12, 1964

(6867) The press release was reported on the Dow Jones broad tape and in the Wall Street Journal, the New

York Herald Tribune, and other morning newspapers throughout the country on April 13, 1964.

The SEC has contended that the press release was materially false and misleading in view of the facts as to the exploratory activities at Timmins at the time of its issuance, and hence violated Rule 10b-5(2) which provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> * * *
>
> (2) to make any untrue statement of a materal fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, * * *
>
> * * *
>
> in connection with the purchase or sale of any security."

In interpreting the "in connection with" requirement of Rule 10b-5, the Court of Appeals held that:

> "* * * Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public * * * if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." 401 F.2d at 862.

(6868) To determine whether the press release was false and misleading, the Court of Appeals directed this court to make "an appropriate primary inquiry into the meaning of the statement to the reasonable investor and its relationship to truth." *Ibid.*[1] The Court of Appeals

1. A summary of the exploratory activities at Timmins is set forth in 258 F.Supp. at 269-73 and 401 F.2d at 843-44, 846-47, and are analyzed in 401 F.2d at 862, n. 28.

stated that, "The speculators and chartists of Wall and Bay Streets are also 'reasonable' investors entitled to the same legal protection afforded conservative traders." *Id.* at 849. From the record before it, the Court of Appeals could not,

> "by applying the standard Congress intended, definitely conclude that it was deceptive or misleading to the reasonable investor, or that he would have been misled by it. * * * Accordingly, we remand this issue to the district court that took testimony and heard and saw the witnesses *for a determination of the character of the release in the light of the facts existing at the time of the release,* by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it.
>
> "In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence." *Id.* at 863. (Emphasis added.)

Character of the Release

At the hearing, the court heard the testimony of seven witnesses and received the depositions of 28 witnesses taken prior to the hearing. Twenty shareholders testified that they sold their shares from April 12 through April 16, 1964 because of the press (6869) release. Twelve shareholders testified that they retained their shares or purchased shares after they became aware of the press release. The shareholders stated that they heard of the press release from the Dow Jones broad tape or accounts in the Wall Street Journal or their daily newspapers, published on April 13, 1964, or from their brokers who had obtained the information from these sources.

The shareholders who sold their shares testified that they were misled by certain words in the press release such

as "without factual basis,"[2] "misleading,"[3] "premature,"[4] and "exaggerated,"[5] which indicated to them that the rumors as to the Timmins discovery were unfounded[6] and that there was either no discovery or, if there was, it was not as rich as it was rumored to be.[7]

Nine of the shareholders who sold[8] offered reasons similar to those given by Wentworth who testified:

> "Well, I had noticed that the market on this particular stock was moving up for some little time before that, several weeks, at least * * * And I was curious to know what was causing it, and I supposed at the time that it was because they anticipated larger earnings, maybe increased dividends from their sulphur, potash, and phosphate operations * * * Now * * * when I read this statement in the Wall Street Journal, an officer of the company, I think his name was Fogarty, he mentioned that these rumors—I'm not quoting his exact words, but my recollection of it—he mentioned that these rumors were misleading. I don't remember his exact words, but the substance he was saying was (6870) they were not reliable and misleading. Then I woke up to the fact that this increase in the stock was due to the street rumor, probably, that they had made a find in the Timmins area, and according to my recol-

2. Stotler, Clement, Weinstein, Kane.

3. Stotler, Patenaude, Clement, Kuhlmann, Harutun, Wentworth, Jahss, Kane.

4. Patenaude, Clement, Kuhlmann, Harutun, Jahss.

5. Jay, Weinstein, Ostroff.

6. Stotler, Kane.

7. Jay, Jahss, Kuhlmann.

8. Feeley, Stotler, Patenaude, Kuhlmann, Jay, Harutun, Borden, Ostroff, Kane.

> lection, that stock did dip some at that time.[9] And I decided that the stock had peaked due to these rumors and that instead of holding the stock as it was my original intention, I had better sell it and buy when it went lower."

Shareholders who retained their shares or purchased shares testified that they noted such words as "preliminary"[10] and the promise of a later "definite statement"[11] or considered the press release as a whole. Funk, who purchased shares after reading the Wall Street Journal account of the press release, testified that, "you don't really pick out a line of an article, you have to read between the lines * * * and the total nature of this article was just a cautious approach * * *"

Whereas some shareholders seized upon the words "premature and possibly misleading" to indicate that TGS had no discovery, others testified that these words meant that TGS "had something" but "that they [TGS] didn't know exactly what."[12] Similarly, witness Jay had seized upon the word "exaggerated" to indicate that TGS had no discovery, while Mann testified as to "exaggerated":

> "Well, it wasn't that part of the statement that I regarded as optimistic, but I think he was referring to the criticism that Canadian authorities were making which were published, that there were all kinds of (6871) wild rumors, not only of Texas Gulf Sulphur, but of many other mining companies in Canada, and

9. Whereas the price of TGS did begin to drop after April 12, movement of TGS stock prices was nearly identical to that of Freeport Sulphur and Pan American Sulphur. The closing prices on the three stocks on April 10, 13, 14, and 15, 1964, were as follows: TGS (30⅛, 30⅞, 30¼, 29⅜—drop of ¾); Freeport (38½, 39½, 39, 38—drop of ½); Pan American (33⅞, 33⅞, 32¼—drop of 1⅝).

10. Rhodes, Gwynne, Mann.

11. Gwynne, Crowley, Mann.

12. Shimberg Wochnik.

> the market was going too high, there was no basis for it."

All of the shareholders appear to have been reasonable investors as that term has been defined by the Court of Appeals, and all were influenced by the press release, some selling their shares, and others holding their shares or purchasing shares.

Finding that the witnesses were reasonable investors, the court is next directed to determine whether those who sold their shares were misled by the press release. The Court of Appeals stated that, "Examined in retrospect, the situation in Timmins at the time the release was prepared seems to offer good reason for optimism." *Id.* at 862, n.28. In his concurring opinion, Judge Friendly found that, "To say that the drilling at Timmins had afforded only 'preliminary indications that more drilling would be required for proper evaluation of this prospect,' was a wholly insufficient statement of what TGS knew * * *" *Id.* at 866. Judge Hays, concurring in part and dissenting in part, held that, "* * * the evidence establishes as a matter of law that the press release was misleading. Indeed, if the correct standard is applied, the finding of the trial court requires the conclusion that the press release was misleading * * *" *Id.* at 869. Also, the press release has been held to be "* * * misleading, intentionally deceptive, inaccurate, and (6872) knowingly deficient in material facts pertaining to the results of drilling." *Reynolds* v. *Texas Gulf Sulphur Co.*, —— F. Supp. ——, ¶92,494 CCH Fed. Sec. L. Rep. 98,317 (D. Utah, October 17, 1969). Revised opinion filed January 13, 1970.

The testimony of the witnesses who sold their shares at a time when the situation in Timmins "seem[ed] to offer good reason for optimism" establishes that they sold because of the press release, and that they were misled by it. It was not necessary that the SEC establish that the selling shareholders were influenced to sell their shares

solely because of the press release. It is enough that it materially influenced the shareholders' conduct and was a substantial factor in bringing about their sales. *See* Prosser, *Law of Torts,* §103, p. 730 (1964).

The court must next determine whether the reasonable investors who were misled by the press release would have been so misled had they exercised due care. TGS argues that no reasonable investor exercising due care would have been misled and caused to sell his stock on the basis of the press release. Emphasizing the promise of a "definite statement" at a future time "[w]hen we have progressed to the point where reasonable and logical conclusions can be made. * * *" TGS urges that the exercise of "due care" required that the shareholders await the further statement before selling their shares. Kane testified, however, that he decided to sell and not await the promised statement (6873) because:

> "I decided that the statement as issued April 12th and quoted in the Wall Street Journal on April 13th, was emphatic enough and strong enough for me to base an investment decision on."

Since the press release had misled reasonable investors to believe that there was no ore discovery, or if there was, it was not as rich as it was rumored to be, they were entitled to act without awaiting a second release.

Therefore, the court finds that some reasonable investors, exercising due care, were misled by the press release.

Due Diligence

There remains the question whether the framers of the press release failed to exercise due diligence.[13] The Court of Appeals stated that:

13. "The trial court did not find it necessary to decide whether TGS exercised such diligence and has not yet attempted to resolve this issue. While the trial court concluded that TGS had exercised 'rea-

> "In the event that it is found that the statement was misleading to the reasonable investor it will then become necessary to determine whether its issuance resulted from a lack of due diligence." *Id.* at 863.

However, the majority opinion goes on to say:

> "It is not altogether certain from the present record that the draftsmen could, as the SEC suggests, have readily obtained current reports of the drilling progress over the weekend of April 10-12, but they certainly should have obtained them if at all possible for them to do so. However, even if it were not possible to evaluate and transmit current data in time to prepare the release on April 12, it would seem that TGS could have delayed the preparation a bit until an accurate report of the rapidly changing situation was possible. See 258 F.Supp. at 296. At the very least, if TGS felt (6874) compelled to respond to the spreading rumors of a spectacular discovery, it would have been more accurate to have stated that the situation was in flux and that the release was prepared as of April 10 information rather than purporting to report the progress 'to date.' Moreover, it would have obviously been better to have specifically described the known drilling progress as of April 10 by stating the basic facts. Such an explicit disclosure would have permitted the investing public to evaluate the 'prospect' of a mine at Timmins without having

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sonable *business* judgment under the circumstances' 258 F.Supp. at 296 (emphasis supplied) it applied an incorrect *legal* standard in appraising whether TGS should have issued its April 12 release on the basis of the facts known to its draftsmen at the time of its preparation, 258 F. Supp. at 295, and in assuming that disclosure of the full underlying facts of the Timmins situation was not a viable alternative to the vague generalities which were asserted. 258 F. Supp. at 296." *Id.* at 863. (emphasis in original.)

to read between the lines to understand that preliminary indications were favorable—in itself an understatement.

> "The choice of an ambiguous general statement rather than a summary of the specific facts cannot reasonably be justified by any claimed urgency. The avoidance of liability for misrepresentation in the event that the Timmins project failed, a highly unlikely event as of April 12 or April 13, did not forbid the accurate and truthful divulgence of detailed results which need not, of course, have been accomplished by conclusory assertions of success. Nor is it any justification that such an explicit disclosure of the truth might have 'encouraged the rumor mill which they were seeking to allay.' 258 F. Supp. at 296." *Id.* at 863-64.

Judge Friendly, in his concurring opinion, stated that the press release "* * * was a wholly insufficient statement of what TGS knew," *Id.* at 866, and Judge Hays, concurring in part and dissenting in part, added:

> "* * * since Fogarty and those who assisted him in the preparation of the press release were aware of the drilling results to which the district court's finding refers, they obviously did not use due diligence in the preparation of the misleading press release." *Id.* at 869-70.

(6875) From the foregoing, it appears that a majority of the Court of Appeals were of the view that the framers of the press release failed to exercise due diligence. No additional evidence was presented at the hearing supporting TGS's contention that the framers exercised due diligence.

While the Court of Appeals recognizes that "* * * the timing of disclosure is a matter for the business judgment

of the corporate officers * * *," *Id.* at 850, n.12, when a company chooses to issue a press release to respond to spreading rumors regarding its activities, it must describe the true picture at the time of the press release, which should include the basic facts known, or which reasonably should be known to the draftsmen of the press release, enabling the investing public to make a reasonable appraisal of the existing situation.[14]

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14. Where technical geological data is involved, consideration should be given to a recent release of the SEC regarding the effect of corporate disclosure upon the investing public in the related petroleum field. Portions of the release, issued on October 20, 1969, and entitled, "Publicity Concerning Petroleum Discoveries on North Slope of Alaska," follow:

> "The Securities and Exchange Commission today expressed its concern with the effect which publicity being given the oil and gas discoveries in the North Slope area of Alaska may have upon public investors. Such publicity may stimulate public interest and give rise to estimates of potential values beyond justification by the factual information now available. * * *
>
> "Oil companies which have oil exploration and development interests on the North Slope are cautioned to weigh carefully the conclusions and interpretations of information they may use in statements released to the public * * * which describe the results of exploration and drilling programs which have been carried out.
>
> "It is the policy of the Commission to encourage prompt disclosure of material developments in the affairs of publicly owned companies. Such disclosure, however, should not be false or misleading. * * *
>
> "* * * Investors unfamiliar with the technical aspects of the oil and gas business—and these may include most shareholders of major oil companies—could ignore or miscontrue the difference between categories of reserves and would attribute to any numerical estimates of reserves in other categories [than 'proved'] a degree of certainty which is not warranted.* While the absence of proved reserve does not preclude factual disclosures of exploratory activities such as information relating to drilling operations, any statements which are made should be appropriately qualified to indicate the limitations upon the significance of the facts disclosed."
>
> * See *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968).

On the basis of the standards laid down by the Court of Appeals, this court finds that the framers of the press release failed to exercise due diligence. Therefore, the press release is found to have been misleading to the reasonable investor using due care, and since the framers did not exercise due diligence in its issuance, TGS violated Section 10(b) and Rule 10b-5.

TGS contends that it can only be held responsible for the press release itself, not for the "inaccurate or incomplete" (6876) version carried by the news media, and emphasizes that none of the witnesses who sold their shares actually saw the press release. TGS refers in particular to the Dow Jones broad tape transmission of April 13, which follows:

"April 13, 1964

"TEXAS GULF SULPHUR

"TEXAS GULF SULPHUR CO CALLED REPORTS THAT IT HAS DISCOVERED A LARGE LODE OF RICH COPPER ORE IN CANADA—PREMATURE AND POSSIBLY MISLEADING—RUMORS OF A GIANT COPPER STRIKE NEAR TIMMINS ONTARIO CAUSED HEAVY TRADING IN MINING STOCKS FRIDAY ON THE TORONTO STOCK EXCHANGE—CHARLES F FOGARTY EXECUTIVE VICE PRESIDENT OF TEXAS GULF SULPHUR ISSUED A STATEMENT SAYING THE REPORTS—EXAGGERATE THE SCALE OF OPERATIONS AND MENTION PLANS AND STATISTICS OF SIZE AND GRADE OF ORE THAT ARE WITHOUT FACTUAL BASIS AND HAVE EVIDENTLY ORIGINATED BY SPECULATION OF PEOPLE NOT CONNECTED TITH [sic] TGS—"

TGS claims that the Dow Jones paragraph is an incomplete restatement of the press release. In particular, the company points to the omission of its promise that "[w]hen we (6877) have progressed to the point where reasonable and logical conclusions can be made, TGS will issue a definite statement * * *"

TGS also contends that the Wall Street Journal distorted the release by taking the words "without factual

basis" out of context and using them as a sub-headline, which the company thinks may have given the impression that they had denied even the possibility that a strike might be proven through further drilling.

By issuing the press release "For Immediate Release," TGS was depending on the news media to report it to its shareholders. They could not have expected the news media to publish the entire press release, but only those portions which the media deemed important. Had TGS considered it important that its shareholders be presented with the full text of the press release, TGS could have sent individual copies to each shareholder through the mails.

Indeed, the fact that the news media emphasized the words which have been found to be misleading to the reasonable investor merely indicates that the news media also deemed them of importance. The failure of the broad tape to mention that a later statement would be issued indicates only that Dow Jones considered it relatively unimportant. No evidence was adduced at the hearing to establish unfair treatment by the news media.

(6878) *Application for an Injunction*

Having found that TGS violated Section 10(b) and Rule 10b-5, the court must now determine whether the SEC is entitled to an injunction. The SEC seeks a permanent injunction, pursuant to Section 21(e) of the 1934 Act, restraining TGS from violating Section 10(b) and Rule 10b-5 in connection with the issuance of future corporate announcements to the public. Section 21(e) provides in pertinent part:

> "Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this chapter, or of

> any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States * * * to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted. * * *"

The Supreme Court has made it clear that "the cessation of violations, whether before or after the institution of a suit * * * is no bar to the issuance of an injunction * * *" and that the issuance of an injunction is subject to principles of equitable discretion. *Hecht Co.* v. *Bowles,* 321 U.S. 321, 327 (1944).

Section 21(e) requires that "a proper showing" be made before a permanent injunction may be granted. In *S.E.C.* v. *Culpepper,* 270 F.2d 241, 249 (2d Cir. 1959), the Court of Appeals stated that, "The critical question for the court in cases such (6879) as this is whether there is a reasonable expectation that the defendants will thwart the policy of the Act by engaging in activities proscribed thereby." Mr. Justice Clark observed in *United States* v. *W. T. Grant Co.,* 345 U.S. 629, 633 (1953):

> "The case may nevertheless be moot if the defendants can demonstrate that 'there is no reasonable expectation that the wrong will be repeated.' The burden is a heavy one. * * *
>
> "Along with its power to hear the case, the court's power to grant injunctive relief survives discontinuance of the illegal conduct. The purpose of an injunction is to prevent future violations, and, of course, it can be utilized even without a showing of past wrongs. But the moving party must satisfy the court that relief is needed. The necessary determination is that there exists some cognizable danger of recurrent violation, something more than

> the mere possibility which serves to keep the case alive." (citations omitted.)

Professor Loss has suggested that, "The ultimate test is whether the defendant's past conduct indicates * * * that there is a reasonable likelihood of further violations in the future." 3 Loss, *Securities Regulation,* 1976 (1961).

In its earlier opinion this court stated:

> "[I]t is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment.
>
> * * *
>
> "Moreover, the circumstances under which the April 12 release was prepared indicate that the defendants Fogarty and Mollison were under considerable pressure. If they had said too much, they would have been open to criticism and possible liability if it turned out that TGS had not discovered a commercial mine. If they said too little and later announced a mine, they subjected themselves to the charge that (6880) their press release was misleading or deceptive—and, indeed, this is what has happened. If they had announced the drilling results in terms of number of drill holes, footage drilled and mineralization intersected, they would have encouraged the rumor mill which they were seeking to allay. Perhaps they should have waited until they could have obtained more probative information before issuing a press release, particularly since developments were breaking so rapidly. However * * * TGS must not be judged by hindsight. In seeking the advice of Mollison, the head of TGS's exploration group, in consulting with TGS's public relations firm, and in clearing the release with one

> of TGS's lawyers, Stephens and Fogarty exercised reasonable business judgment under the circumstances." 258 F.Supp. at 294, 296.

In the Court of Appeals, Judge Friendly observed in his concurring opinion that while the press release did not properly convey the information in the hands of the draftsmen on April 12,

> "[I]t does not necessarily follow that this is an appropriate case for granting an injunction as to future press releases. * * * Here there is no danger of repetition of an unduly gloomy press release like that of April 12. The essence of the SEC's case is that Timmins was a once-in-a-lifetime affair; the company's motive in issuing the release was laudable; and the defect was solely a pardonable one of execution." 401 F.2d at 868-69.

The issuance of an injunction is inappropriate absent a showing of lack of good faith. "Scienter and Rule 10b-5," 69 Col. L. Rev. 1057, 10[illegible]6 (1969); 82 Harv. L. Rev. 938, 947-48 (1969).

(6881) Finally, the Court of Appeals' "due diligence" test is here being applied for the first time.

On the record here, there is no "proper showing" that there is any reasonable likelihood of future violations by TGS of Section 10(b) and Rule 10b-5. The press release was issued over five years ago, and no subsequent misleading press releases have been called to the court's attention.

Accordingly, the SEC's application for "the issuance of a final judgment permanently enjoining the defendant TGS * * * from issuing, publishing, distributing or otherwise disseminating materially false, misleading, inadequate, or inaccurate press releases and other communica-

tions and reports concerning material facts about TGS's activities and operations" is denied.[15]

III. Remedy as to the Individual Defendants

This court found that defendants Clayton and Crawford had violated Section 10(b) and Rule 10b-5 in that they purchased TGS stock on the basis of material inside information concerning the results of TGS drilling in Timmins, Ontario, while such information remained undisclosed to the investing public. The Court of Appeals affirmed this court's determination as to Clayton[16] and Crawford and in addition ruled:

(6882) (1) that defendants Fogarty, Mollison, Darke, Huntington, Holyk, and Coates had violated Section 10(b) and Rule 10b-5 in that they purchased TGS stock or calls on the basis of material undisclosed information; (2) that defendants Darke and Coates[17] had violated Section 10(b) and Rule 10b-5 in that they recommended the purchase of TGS stock to others while the material information was undisclosed to the investing public; and (3) that defendants Stephens, Fogarty, and Kline had violated Section 10(b) and Rule 10b-5 in that they accepted stock options without disclosing the material information to the Stock Options Committee or the Board of Directors of TGS.[18]

15. This renders it unnecessary to consider TGS's defense that the issuance of an injunction would violate the company's rights under the First Amendment.

16. While this court found that only Clayton's purchase on April 15, 1964 was a violation of Section 10(b) and Rule 10b-5, the Court of Appeals held that all of his purchases during the period of nondisclosure, from November 12, 1963 through April 16, 1964, were violations of these provisions.

17. A stipulation was signed by the parties settling the SEC's action against Coates, and a judgment was entered pursuant thereto on October 2, 1969.

18. Defendant O'Neill has not appeared or answered. A motion by the SEC to enter a default judgment against him was denied by this court without prejudice to its renewal following final disposition of the appeal, and the SEC renewed its motion of September 26, 1969. Disposition of the motion will be the subject of a separate memorandum.

There remains for determination the appropriate remedy to be applied to these defendants.

Defendants Who Purchased or Recommended Purchases of Stock or Calls

With respect to the defendants who were found to have violated Section 10(b) and Rule 10b-5 in that they purchased TGS stock or calls or recommended its purchase to others while in possession of material undisclosed inside information, the SEC urges that the court:

(6883) 1) issue an order under Section 21(e) of the 1934 Act enjoining,

Injunctive Relief—

a) defendants Clayton, Holyk, Huntington, Darke, Fogarty, Crawford, and Mollison from violating Section 10(b) and Rule 10b-5 in connection with their purchases or sales of the securities of TGS (or calls in TGS securities) on the basis of material undisclosed inside information;

b) defendant Darke from recommending the purchase of TGS stock while in possession of material undisclosed inside information; and

Other Relief—

2) decree that defendants Clayton, Holyk, Huntington, and Darke be deprived of the profits they realized through their use of material undisclosed inside information and that defendant Darke be required to pay an amount equal to the profits of those persons who purchased TGS

stock on his recommendation or that of his "tippees."[19]

Injunctive Relief

The SEC asserts that the defendants' past violations were not accidental or inadvertent, but knowing, and that the fact that defendants continue to maintain that they have done nothing wrong creates a reasonable expectation that such violations will occur in the future unless an injunction issues. Moreover, the SEC points out that all these defendants, with the exception of Darke, still hold important positions with TGS—positions which presumably bring material confidential information to their attention.

(6884) On the other hand, these defendants emphasize that the only transactions for which they have been held to have violated Rule 10b-5 occurred more than five years ago and that there is no evidence that since that time they have violated the securities laws, or are about to violate them. Defendants rely on *Hecht Co.* v. *Bowles*, 321 U.S. 321, 329 (1944) and *Electronics Specialty Co.* v. *International Controls Corp.*, 409 F.2d 937, 947 (2d Cir. 1969), for the proposition that, "The historic injunctive process was designed to deter, not to punish." It would be inappropriate, these defendants say, to enjoin them "for failing to have the prescience to know that their conduct would be adjudged unlawful under a statute and rule which did not expressly prohibit that conduct and which had not previously been interpreted to prohibit it." Finally, defendants urge the court to consider the punishment they have already suffered by reason of the wide adverse publicity.

19. As defendants Fogarty, Mollison, and Crawford have sold the shares which they purchased from November 12, 1963 through April 16, 1964 to TGS at cost, the SEC seeks no relief other than an injunction with respect to them.

In considering the remedy of injunction, it is noted that defendant Darke is a Canadian living in Canada. He is no longer in the employ of TGS, and hence no longer privy to any material inside information with respect to its activities. The material undisclosed information possessed by Darke when he made his purchases and recommended TGS securities to others was disclosed in the April 16, 1964 press release (6885) announcing TGS's discovery. The SEC seeks injunctions only with respect to trading in TGS securities on the basis of TGS material undisclosed information. Since Darke no longer has the opportunity, no useful purpose would be served by the issuance of an injunction, but the SEC will be accorded "other relief" to the extent hereinafter provided.

Defendants Holyk, Huntington, Fogarty, and Mollison are still in the employ of TGS. The record makes it clear that the discovery on the Kidd 55 segment was a once-in-a-lifetime affair. The violations occurred more than five years ago, and there is no evidence that any of these defendants have been guilty of further violations. Professor Painter points out that the application of the "materiality" test by the Court of Appeals "represents a considerable extension of the meaning of 'materiality' into new areas." Painter, *Federal Regulation of Insider Trading,* 220 (1969). These defendants could not have anticipated this extension at the time of their violations, but they, as indeed all insiders, are now on notice of the scope of Section 10(b) and Rule 10b-5. It is believed that the wide publicity accorded to these defendants will serve as an adequate deterrent, when coupled with the fact that none of these defendants will retain the profits which they realized by reason of their violations. Fogarty and Mollison have (6886) surrendered to TGS, at their cost, the shares which they purchased, and by the applications of the "other relief" sought by the SEC, Holyk and Hunting-

ton will be deprived of any profit they made by reason of their violations. The purpose of an injunction is to deter and not to punish. *Hecht Co.* v. *Bowles, supra; Electronics Specialty Co.* v. *International Controls Corp., supra.*

For the foregoing reasons, finding no reasonable likelihood of further violations, injunctions will not issue with respect to defendants Darke, Holyk, Huntington, Fogarty, and Mollison.

Defendants Clayton and Crawford are in a different position because they purchased during the period of nondisclosure knowing beyond peradventure of a doubt that TGS had made a very important mineral discovery. Because of this and reasons hereinafter stated, injunctions will issue with respect to them.

Other Relief

The SEC urges the court to deprive defendants Darke, Holyk, Huntington, and Clayton of their profits in order to remove any monetary reward for violations of Section 10(b) and Rule 10b-5.

The defendants contend that the SEC's only remedy is for an injunction or restraining order under Section 21(e), (6887) and that this court has no power to direct "other relief," whether or not ancillary to an injunction.

Judicial willingness to imply new remedies in areas governed by federal law has been expressed in a number of ways. *See* Comment, "SEC Enforcement of the Rule 10b-5 Duty to Disclose Material Information—Remedies and the Texas Gulf Sulphur Case," 65 Mich. L. Rev. 944, 945-54 (1967).

When such relief has been necessary for the protection of the investing public, the courts have utilized their inherent equity power to grant relief ancillary to an injunction. Thus a receiver was appointed ancillary to an injunc-

tion under Section 21(e) in *S.E.C.* v. *H.S. Simmons & Co.*, 190 F.Supp. 432 (S.D.N.Y. 1961), and in *S.E.C.* v. *Wong*, 252 F.Supp. 608, 613 (D.P.R. 1966), the court, denying defendant's motion to dismiss that portion of the SEC's complaint seeking an accounting and restitution, stated that, "Where appropriate, this Court may utilize its inherent equity powers, invoked by an injunctive action under Section 36 [of the Investment Company Act, 15 U.S.C. §80a-35], to do justice and grant full relief."

Ancillary relief in other areas[20] indicates that the doctrine is sufficiently well established to support the relief here sought by the SEC if the congressional purpose is effectuated by so doing. *See*, 65 Mich. L. Rev., *supra* at 946-48, (6888) 3 Loss, *supra* at 1827-28; Cary, Book Review, 75 Harv. L. Rev. 857, 861 (1962); "Ancillary Relief in SEC Injunction Suits for Violation of Rule 10b-5," 79 Harv. L. Rev. 656 (1966).

In *Textile Workers* v. *Lincoln Mills*, 353 U.S. 448 (1957), the Supreme Court held that the congressional grant of jurisdiction in Section 301(a) of the Labor Management Relations Act of 1947, 29 U.S.C. §185, "authorize[d] federal courts to fashion a body of federal law for the enforcement of these collective bargaining agreements * * *." *Id.* at 451, and that the law to be applied in such suits "is federal law, which the courts must fashion from the policy of our national labor laws." *Id.* at 456.

This action was instituted pursuant to Section 27 of the 1934 Act, which provides:

> "The district courts of the United States * * * shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought

20. *Porter* v. *Warner Holding Co.*, 328 U.S. 395 (1946)—Emergency Price Control Act of 1942; *Mitchell* v. *Robert DeMario Jewelry, Inc.*, 361 U.S. 268 (1960)—Fair Labor Standards Act of 1938.

> to enforce any liability or duty created by this chapter or the rules and regulations thereunder."

In *J.I. Case Co.* v. *Borak,* 377 U.S. 426, 433 (1964), the Supreme Court, invoking the *Lincoln Mills* rationale, and basing its determination on Section 27 rather than on either the ancillary or statutory tort doctrines, stated that:

> (6889) "* * * it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the congressional purpose * * *. It is for the federal courts 'to adjust their remedies so as to grant the necessary relief' where federally secured rights are invaded."

The Supreme Court recently followed this rationale in *Mills* v. *Electric Auto-Lite Co.,* —— U.S. ——, 38 U.S.L.W. 4097 (Jan. 20, 1970). The Court concluded that proxies necessary to the approval of a merger were obtained by means of a materially misleading solicitation. *Id.* at 4100. In stating that the conclusion implied nothing about the form of the relief to which plaintiffs were entitled, Justice Harlan went on to say:

> "We held in *Borak* that upon finding a violation the courts were 'to be alert to provide such remedies as are necessary to make effective the congressional purpose,' noting specifically that such remedies are not to be limited to prospective relief. 377 U.S., at 433, 434. * * * In selecting a remedy the lower courts should exercise 'the sound discretion which guides the determination of courts of equity,' keeping in mind the role of equity as 'the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims. *Hecht Co.* v. *Bowles,* 321 U.S. 321, 329-330 (1944)." *Ibid.*

In contrasting the Lanham Act, Justice Harlan said:

> "[W]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." *Id.* at 4101.

As this court has recently stated in *Astor* v. *Texas Gulf Sulphur Co.*, —— F.Supp. —— (S.D.N.Y. 1969), ¶92,501 CCH Fed. Sec. L. Rep. 98,341, 98,345 (Oct. 31, 1969):

> (6890) "The power of the federal courts to 'adjust their remedies' where Rule 10b-5 has been violated, *J.I. Case Co.* v. *Borak, supra* at 433, may be invoked in situations of 'inherent unfairness * * * where a party takes advantage of [undisclosed corporate] information knowing it is unavailable to those with whom he is dealing, *Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961)."

Therefore, the court may, on the basis of Section 27, fashion an appropriate remedy to effectuate the purpose of the 1934 Act, and to deter future violations of Section 10(b) and Rule 10b-5. 65 Mich. L. Rev., *supra* at 954.

The congressional purpose is stated in Section 2 of the 1934 Act (15 U.S.C. §78(b), which provides in part:

> "[T]ransactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary * * * to insure the maintenance of fair and honest markets in such transactions."

In *Burko* v. *S.E.C.*, 316 F.2d 137, 141 (2d Cir. 1953), the Court of Appeals, discussing the 1934 Act, remarked:

> "[I]t is important to remember that the Commission is charged with the duty of enforcing the statute in

> the 'public interest,' * * * and that its orders are intended to be remedial rather than penal, a result of the fact that the 'design of the statute is to protect investors' and the general public in this specialized field."

In seeking to deprive the defendants of their profits in order to remove any monetary reward for violating Section 10(b) and Rule 10b-5, the SEC is urging this court to (6891) provide a remedy which will, in accord with the congressional purpose of the 1934 Act, protect the investing public by providing an effective deterrent to future violations. *See,* 65 Mich L. Rev., *supra* at 963. Accordingly, the court may require the defendants to give up profits realized in transactions which violated Section 10(b) and Rule 10b-5.[21]

Defendants contend that even if this court has the power, the SEC's "other relief" should be denied in the court's discretion. They assert that, "[I]f a sum of money is to be recovered by a third person for violation of a statute instead of the person injured * * * it constitutes a penalty. * * *" *Bowles* v. *Farmers National Bank,* 147 F.2d 425, 428 (6th Cir. 1945), and that, "Anything which savors of a penalty should not be permitted unless Congress has expressly so provided, since the spirit of equity abhorred such punitive measures." *United States* v. *Parkinson,* 240 F.2d 918, 922 (9th Cir. 1956). Defendants also point out that the amount of their profits which the SEC seeks to deprive them of exceeds the statutory maximum fine

21. On October 10, 1969, Judge Weinfeld of this Court entered a judgment, based upon a stipulation between the parties, enjoining future violations and directing the defendants to surrender their profits in *S.E.C.* v. *Golconda Mining Co.,* ¶92,564 CCH Fed. Sec. L. Rep. 98,367 (S.D.N.Y. 1969), an action alleging that defendants violated Section 10(b) and Rule 10b-5 by trading on the basis of inside information.

which could have been levied upon them if they had been found guilty of a criminal violation.

However, as stated by the New York Court of Appeals in *Diamond* v. *Oreamuno,* 301 N.Y.S.2d 78, 81, 24 N.Y.2d 449 (N.Y. Ct. App. 1969),

> (6892) "[T]here can be no justification for permitting officers and directors, such as the defendants, to retain for themselves profits which * * * they derived solely from exploiting information gained by virtue of their inside position as corporate officials."

In its complaint filed in this action, the SEC sought rescission and restitution with respect to defendants who purchased TGS stock or recommended its purchase to others while in possession of material undisclosed information. The SEC now urges that the court follow the formula established in its settlement with defendant Coates, which was approved by this court on October 2, 1969. The Coates settlement provided that he would pay to TGS the estimated amount of "profit" based upon the difference between market price on April 17, 1964 and the price at which the stock was purchased on April 16, 1964. The settlement was $26,250. of which $16,575. represented the "profit" on the stock purchased by Coates for his family trusts, and $9,675. represented the "profit" on stock purchased by Coates' "tippees."

In applying this formula, the SEC proposes that the amount to be paid by each defendant would be the difference between the mean average price of TGS common stock on the New York Stock Exchange on April 17, 1964, which has been stipulated by the parties to be 40⅜, and the purchase price of (6893) their shares, and in the case of calls, the aggregate of the purchase price and the cost of

exercise, with interest from April 17, 1964 at the New York legal rate.[22]

The payments would be made to TGS to be held in escrow in an interest-bearing account for a period of three or more years, subject to disposition in such manner as the court might direct upon application by the SEC or other interested person or on the court's own motion. At the end of the period any money remaining undisposed of would become the property of TGS.[23]

The formula proposed by the SEC is approved as fair. TGS announced its major discovery on the morning of April 16, 1964. The news was widely disseminated by the news media and was available to the investing public on April 17, 1964.[24]

The court believes that the application of the SEC formula to the extent hereinafter provided with respect to each individual defendant will protect the investing public by deterring possible future violations of Section 10(b) and Rule 10b-5. To the payments hereinafter directed to be made, interest will be added at the rate of 6% per

22. It has been stipulated that prior to July 1, 1968, the New York legal rate was 6%; from July 1, 1968 to February 16, 1969 it was 7¼%; and since February 16, 1969, has been 7½%.

23. The Coates settlement included the following provision:

> "* * * except that if Coates or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf stock on April 16, 1964, or the purchases of said stock by H. Fred Haemisegger and his customers, as a result of a judgment in or settlement of any other action commenced prior to the date hereof, Texas Gulf will, at the request of Coates or his estate, apply any or all of the remaining balance of said amount toward the satisfaction of such liability."

24. In *Reynolds* v. *Texas Gulf Sulphur Co., supra,* the court used the average of the highest prices on the 20 days following the April 16, 1964 press release as the standard for computing the damages of plaintiffs who sold their TGS stock in reliance on the April 12, 1964 press release.

annum from April 17, 1964, and the payments will be escrowed by TGS for a period of 5 years. Each of these defendants will now be considered:

(6894) *Darke*—Defendant Darke was a geologist and a member of TGS's exploration group on the Kidd 55 segment. During the period of nondisclosure, from November 12, 1963 through April 16, 1964, Darke made the following purchases:

Date of Purchase	*Shares*		*Calls*	
	Number	*Price*	*Number of Shares*	*Cost of Exercise*
2/20/64	300	24⅛		
2/27/64			1,000	22⅝-22¾
3/23/64			1,000	24¾
3/30/64			1,000	25½

Darke purchased a total of 300 shares and calls on 3,000 shares. Under the SEC formula, his cost is figured at $91,442.58. The price on April 17, 1964, was $133,237.50. Accordingly, Darke will be directed to pay the difference of $41,794.92 to TGS.

During the period of nondisclosure, Darke recommended the purchase of TGS securities to the following persons, whose purchases were as follows:

Date of Purchase	*Purchaser*	*Shares*		*Calls*	
		Number	*Price*	*Number of Shares*	*Cost of Exercise*
12/30/63	Caskey			300	22¼
2/17/64	Atkinson	50	23¼	200	23⅛
3/ 3/64	E.W.Darke			500	22½-22⅝
3/17/64	E.W.Darke			200	23⅜
3/30/64	Atkinson			400	25¾-25⅞
3/30/64	Caskey	100	25⅞	1,000	25¾-25⅞
3/30/64	E.W.Darke			200	25½

(6895) During the period of nondisclosure, the following persons purchased TGS securities on the basis of rec-

ommendations received directly or indirectly from Caskey or Atkinson:

Date of Purchase	*Purchaser*	*Shares*		*Calls*	
		Number	*Price*	*Number of Shares*	*Cost of Exercise*
1/16/64	Westreich	2,000	21¼-21¾		
2/17/64	Westreich	50	23¼	1,000	23¼-23⅝
2/24/64	Miller			200	23¾
2/25/64	Miller			300	23⅜-23½
3/30/64	Klotz			2,000	25½-26⅛
3/30/64	Miller			500	25½-25⅞
3/30/64	Westreich	500	25¾		

As to Darke's "tippees," this court stated:

> "Toward the end of December, 1963, Darke visited Caskey and Atkinson in Washington. The evidence shows no more than that Darke indicated to them that he thought TGS was a good buy. There is no direct evidence that Darke again communicated with any of his 'tippees,' but the record shows that on March 30, 1964, Darke and his 'tippees,' Atkinson, Caskey, E. W. Darke, Klotz, Miller, and Westreich, purchased substantial amounts of TGS stock and calls on TGS stock. As the Commission points out, this is strong circumstantial evidence that Darke must have passed the word to one or more of his 'tippees' that drilling on the Kidd 55 segment was about to be resumed." 258 F.Supp. at 284.

The Court of Appeals added:

> "Obviously if such a resumption were to have any meaning to such 'tippees,' they must have previously been told of K-55-1.
>
> "* * * As it is our holding that the information acquired after the drilling of K-55-1 was material,

> we, on the basis of the findings of direct and (6896) circumstantial evidence on the issue that the trial court has already expressed, hold that Darke violated Rule 10b-5 (3) and Section 10(b) by 'tipping' and we remand, pursuant to the agreement of the parties, for a determination of the appropriate remedy. 401 F.2d at 852 (footnote omitted).

The SEC urges that Darke be required to pay an amount equal to the profits of his "tippees." Accordingly to the SEC's calculations, the profit of Darke's "tippees" which is attributable to him was $141,818.14, as follows:

"Tippee"	*Total Cost*	*Price on 4/17/64*	*Profit Attributable to Darke*
Caskey	$31,772.74	$ 56,625.00	$24,752.26
Atkinson	17,841.43	26,243.75	8,402.32
*E. W. Darke	21,087.50	36,337.50	15,250.00
Westreich	86,275.65	143,331.25	57,056.20
Klotz	56,770.32	80,750.00	23,979.68
Miller	27,997.32	40,375.00	12,377.68
			$141,818.14

*E. W. Darke, the brother of defendant Darke, is a Canadian resident. The SEC has been unable to determine both the cost of the calls purchased by E. W. Darke and whether these calls were exercised. Since the price of TGS stock rose appreciably above the exercise price of these calls, the SEC has assumed that they were exercised.

In considering "other relief" with respect to Darke's "tippees," a distinction will be made between those who purchased TGS securities on Darke's recommendation and those who purchased on the recommendation of one of Darke's "tippees."

(6897) In this court's opinion it will be a sufficient deterrent if Darke is directed to pay to TGS the profits

realized by the "tippees" who purchased on Darke's recommendation (E. W. Darke, Caskey, and Atkinson) in accordance with the SEC formula.

E. W. Darke, Caskey, and Atkinson purchased a total of 150 shares and calls on 2,800 shares. Under the SEC formula, their cost is figured at $70,701.67. The price on April 17, 1964, was $119,106.25, and Darke will be directed to pay the difference of $48,404.58 to TGS—subject to adjustment if Darke furnishes the exact figures as to his brother's purchases of calls and evidence as to whether his brother exercised them—which amount is in addition to the $41,794.92 Darke will be directed to pay with respect to his own purchases.

Holyk—Defendant Holyk was the chief geologist in TGS's exploration group on the Kidd 55 segment. During the period of nondisclosure, Holyk[25] made the following purchases:

(6898)

Date of Purchase	*Shares*		*Calls*	
	Number	*Price*	*Number of Shares*	*Cost of Exercise*
11/29/63	50	18		
12/10/63	100	20⅜		
12/12/63			200	21
1/ 6/64			100	23⅝
1/24/64			200	22¼–22⅜
2/24/64			200	24⅛
2/26/64			200	23⅜
3/ 2/64	200	22⅜		
3/16/64			300	23¼
3/17/64	100	23⅞		
3/30/64	100	25⅞		

25. Several of Holyk's purchases of shares and calls were in the name of his wife or in the names of both spouses. Both this court and the Court of Appeals have treated such transactions as purchases in the defendant's name alone.

Prior to the drilling at Kidd 55, Holyk owned no TGS stock, with the exception of 50 shares which he sold prior to December, 1962.

Holyk purchased a total of 550 shares and calls on 1,200 shares. Under the SEC formula, his cost is figured at $34,992.78. The price on April 17, 1964 was $70,656.25, and Holyk will be directed to pay the difference of $35,663.47 to TGS.

Huntington—Defendant Huntington was a lawyer employed to TGS. During the period of nondisclosure, Huntington made the following purchases:

			Calls	
Date of	*Shares*		*Number*	*Cost of*
Purchase	*Number*	*Price*	*of Shares*	*Exercise*
2/26/64	50	23¼		
3/16/64			100	22⅜

Prior to the drilling at Kidd 55, Huntington owned 50 shares of TGS stock.

(6899) Huntington purchased a total of 50 shares and calls on 100 shares. Under the SEC formula, his cost is figured at $3,755.69. The price on April 17, 1964 was $6,056.25, and Huntington will be directed to pay the difference of $2,300.56 to TGS.

Clayton—Defendant Clayton was employed by TGS as an engineer. During the period of nondisclosure, Clayton made the following purchases:

Date of	*Shares*	
Purchase	*Number*	*Price*
11/13/63	200	17¾
2/24/64	400	23⅞
3/ 3/64	100	22¼
3/26/64	200	25
4/ 1/64	60	26½
4/ 2/64	100	26⅞
4/15/64	200	29⅜

Clayton conducted geophysical surveys including surveys on the Kidd anomaly. While he did not participate in the drilling, he spent a great deal of his time at Timmins and at the Kidd 55 segment, and the evidence establishes that he kept himself fully informed. He testified at a pretrial examination that he thought that, with the results of K-55-6, TGS had a potential ore body. By 7:00 P.M. on April 13, 1964, K-55-6 had been drilled to 949 feet, encountering substantial (6900) mineralization. Indeed, no further mineralization was encountered by K-55-6 after that time. Therefore, this court found that Clayton's April 15 purchase violated Section 10(b) and Rule 10b-5, 258 F.Supp. at 286-87, and the Court of Appeals has ruled that his prior purchase also violated these provisions. In view of the evidence, and in order to deter future violations, Clayton will be enjoined from making any further purchases or sales of TGS securities on the basis of material undisclosed information.

Clayton purchased a total of 1,260 shares of stock at a cost of $30,861.94. Under the SEC formula, the price of these shares on April 17, 1964 was $50,872.50, and Clayton will be directed to pay the difference of $20,010.56 to TGS.

Crawford—Defendant Crawford was a lawyer who was employed by TGS in January, 1964, and was appointed secretary of the company and manager of its public relations on February 20, 1964. During the period of nondisclosure Crawford made the following purchases:

Date of Purchase	*Shares*	
	Number	*Price*
4/16/64	600	30⅛-30¼

(6901) On April 15, 1964, Crawford participated with defendant Fogarty and a representative of Doremus & Co. in the preparation of the April 16 press release an-

nouncing TGS's discovery. The evidence establishes that by the evening of April 15 he was fully familiar with the contents of the press release which was to be issued the following morning.

About midnight on April 15, Crawford telephoned his broker and ordered 300 shares of TGS to be purchased at the opening of the market the next morning. He telephoned his broker again at about 8:30 A.M. on April 16 to increase his order from 300 to 600 shares. This court found that Crawford sought to, and did, "beat the news," and that in so doing, he utilized material undisclosed information to his own advantage in violation of Section 10(b) and Rule 10b-5, 258 F.Supp. at 287. In view of the evidence, and on order to deter future violations, Crawford will be enjoined from making any further purchases or sales of TGS securities on the basis of material undisclosed information.

As Crawford has surrendered to TGS, at his cost, the shares which he purchased, the SEC seeks no "other relief," and the court finds no "other relief" to be necessary. (This is also the case with respect to defendants Fogarty and Mollison—See footnote 19.)

(6902) *Defendants Who Accepted Stock Options*

The Court of Appeals ruled that defendants Stephens, Fogarty, and Kline had violated Section 10(b) and Rule 10b-5 in that they accepted options to purchase TGS stock while they possessed material information which they did not disclose to the Stock Option Committee or the Board of Directors. The SEC urges that the court:

1) issue an order enjoining defendants Stephens, Fogarty, and Kline from violating Section 10(b) and Rule 10b-5 in connection with the acceptance

of options to purchase TGS stock while they possess material undisclosed inside information; and

2) issue an order directing TGS to rescind the option to purchase TGS stock granted to defendant Kline, and directing TGS to cancel his option.

Stephens and Fogarty

Defendants Stephens and Fogarty have surrendered their stock options, which have been cancelled by TGS.

This court stated that Stephens and Fogarty "were under a duty to inform the [Stock Option] Committee of material information affecting the issuance of the stock options." 258 F.Supp. at 292.

The Court of Appeals, finding that the information which Stephens and Fogarty possessed was material, directed this court "to consider in its discretion whether to issue (6903) injunction orders against Stephens and Fogarty." *401 F.2d at 864. Judge Hays thought that* "the injunction sought by the Commission [with respect to Stephens and Fogarty] should be granted." *Id.* at 869.

In his summation, Mr. Kennamer, counsel for the SEC, stated:

> "This is to my knowledge the first case where the Commission has brought an enforcement proceeding involving the issuance of stock options—that is, an enforcement proceeding under Rule 10b-5."

The SEC points out that Stephens as Chief Executive, and Fogarty as President, are privy to non-public material information concerning TGS, and assert that "all of the ingredients [for further violations of Section 10(b) and Rule 10b-5] are present." The SEC argues that the failure to inform the Stock Option Committee of material infor-

mation affecting the issuance of the stock options breached a well recognized duty which raises the inference of future violations. Therefore, the SEC seeks an injunction with respect to Stephens and Fogarty.

However, since Stephens and Fogarty have surrendered their stock options to TGS, they have realized no profit by reason thereof. In view of the wide publicity given to this case and the reporting requirements of the 1934 Act, there (6904) seems to be little likelihood that these senior officers of TGS would accept future stock options without disclosing what they know to the Stock Option Committee and the Board of Directors. For these reasons, injunctions will not issue with respect to defendants Stephens and Fogarty.

Kline

This court found that Kline was not in the possession of material undisclosed information at the time he accepted his stock option, stating:

> "Defendant Kline was informed by defendants Stephens and Fogarty at lunch in November 1963 that TGS was conducting explorations in the Timmins area and that the completion of the first drill hole was a favorable development; that it was on the boundary of the TGS property and that TGS was interested in acquiring additional property. He knew no details and his only information came from his superiors." 258 F.Supp. at 291.

The Court of Appeals, finding that the information which Kline possessed was material and that he was under a duty before accepting his option to disclose any material information he may have possessed, "direct[ed] that an order issue rescinding the option granted Kline and that such further remedy be applied against him as may be

proper by way of an order of restitution." 401 F.2d at 864. This is the only instance where the Court of Appeals directed a specific remedy (6905) as to any of the defendants, it having previously stated:

> "Pursuant to a stipulation by all the parties, the question of the appropriate remedies to be applied was deferred pending a final determination whether the defendants or any of them had violated Section 10(b) and Rule 10b-5 and therefore that question is not now before us." *Id.* at 839, n. 1.

While this court believes that the remedy directed with respect to Kline merits reconsideration in the event the matter is again presented to the Court of Appeals, this court is bound by its directions. Therefore, the judgment to be entered will direct Kline to surrender to TGS his stock option heretofore granted on February 20, 1964 covering 4,300 shares of stock, and will direct TGS to rescind and cancel Kline's stock option.

In seeking an injunction against Kline as to future violations, the SEC asserts that "the failure of Kline, who was then Secretary and is now General Counsel of Texas Gulf, to indulge his knowledge concerning the drilling in Timmins to the Stock Option Committee or Board of Directors before accepting stock options, raises the inference that future violations may be reasonably expected, and therefore an injunction should issue." For the reasons stated with respect to defendants Stephens and Fogarty, there seems little likelihood that Kline will accept future stock options without disclosing (6906) what he knows. Therefore, the SEC's application for an injunction is denied.

From what has been said in this opinion, it should be clear that if any of the defendants not here enjoined should again violate Section 10(b) and Rule 10b-5, the remedy of

injunction, in addition to other remedies, would be appropriate.

The foregoing, together with this court's opinion reported at 258 F.Supp. 262, and the Court of Appeals' opinions reported at 401 F.2d 833, constitutes the court's findings of fact and conclusions of law. Rule 52(a), F.R. Civ.P.

The parties may settle final judgments in accordance herewith.

It is so Ordered.

Dated: New York, N.Y.
February 6, 1970.

Dudley B. Bonsal
U. S. D. J.

Appendix A

Judgment of the District Court

(6929)

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

[SAME TITLE]

This action having first been brought on for trial before the Honorable Dudley B. Bonsal, United States District Judge, on May 9, 10, 11, 12, 13, 23, 24, 25, 26, 27, 31 and June 1, 2, 3, 6, 7, 8 and 21, 1966, and the Court thereafter having handed down its opinion decision, dated August 16, 1966, and filed on August 19, 1966, constituting the Court's findings of fact and conclusions of law and directing the entry of judgment dismissing the complaint as to all defendants except Richard H. Clayton and David M. Crawford, and said judgment having been entered on August 22, 1966, and said judgment having been affirmed in part and reversed in part by an opinion decision of the United States Court of Appeals for the Second Circuit dated August 13, 1968, and the cause having been remanded for further proceedings, and this action having further come on for hearing before the Honorable Dudley B. Bonsal on October 6, 7 and 8, 1969, and the Court thereafter having handed down its (6930) opinion decision, dated and filed February 6, 1970, which together with such findings of fact and conclusions of law contained in this Court's prior opinion dated August 16, 1966, and filed August 19, 1966, as were sustained by the opinion rendered on August 13, 1968, by the United States Court of Appeals for the Second Circuit, constitutes the Court's findings of fact and conclusions of law, and the Court having found that the defendants Clayton, Crawford, and Texas Gulf Sulphur Company had violated Section 10(b) of the Securities Exchange Act

of 1934 and Rule 10b-5, and the Court of Appeals having ruled that defendants Fogarty, Mollison, Darke, Huntington, Holyk, Stephens, and Kline had violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, it is

ORDERED AND DECREED that defendants Richard H. Clayton and David M. Crawford are enjoined from engaging in the purchase or sale of Texas Gulf Sulphur Company securities on the basis of undisclosed material information relating to Texas Gulf Sulphur Company acquired by said defendants by reason of any relationship with Texas Gulf Sulphur Company or its agents and employees, and it is further

ORDERED AND DECREED that, there being no proper showing of any reasonable likelihood of future violations, injunctive relief against defendants Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Kenneth H. Darke, Earl L. Huntington, Walter Holyk, Claude O. Stephens, and Harold B. Kline be, and the same hereby is, denied, and it is further

(6931) ORDERED AND DECREED that the defendant Kenneth H. Darke pay over to Texas Gulf Sulphur Company the amount of $90,199.50, with interest at 6% from April 17, 1964, such amount to be held by Texas Gulf Sulphur Company in escrow in an interest bearing account for five years, subject to disposition in such manner as the Court may direct upon application by the Securities and Exchange Commission or other interested person or upon the Court's own motion, at the end of such period such amount as may remain to become the property of Texas Gulf Sulphur Company, except that if Kenneth H. Darke or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf Sulphur Company securities

during the period November 12, 1963, through April 16, 1964, or by reason of any recommendation by him to others concerning Texas Gulf Sulphur Company securities during the same period, as a result of a judgment in or settlement of any other action, Texas Gulf Sulphur Company will, at the request of Kenneth H. Darke or his estate, apply said amount toward the satisfaction of such liability, and it is further

ORDERED AND DECREED that the defendant Walter Holyk pay over to Texas Gulf Sulphur Company the amount of $35,663.47 with interest at 6% from April 17, 1964, such amount to be held by Texas Gulf Sulphur Company in escrow in an interest bearing account for five years, subject to disposition in such manner as the Court may direct upon application by the Securities and Exchange Commission or other interested person or upon the Court's own motion, at the end of such period such amount as may remain to become the property of Texas Gulf Sulphur Company, (6932) except that if Walter Holyk or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf Sulphur Company securities during the period November 12, 1963, through April 16, 1964, as a result of a judgment in or settlement of any other action, Texas Gulf Sulphur Company will, at the request of Walter Holyk or his estate, apply said amount toward the satisfaction of such liability, and it is further

ORDERED AND DECREED that the defendant Earl L. Huntington pay over to Texas Gulf Sulphur Company the amount of $2,300.56, with interest at 6% from April 17, 1964, such amount to be held by Texas Gulf Sulphur Company in escrow in an interest bearing account for five years, subject to disposition in such manner as the Court may

direct upon application by the Securities and Exchange Commission or other interested person or upon the Court's own motion, at the end of such period such amount as may remain to become the property of Texas Gulf Sulphur Company, except that if Earl L. Huntington or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf Sulphur Company securities during the period November 12, 1963, through April 16, 1964, as a result of a judgment in or settlement of any other action, Texas Gulf Sulphur Company will, at the request of Earl L. Huntington or his estate, apply said amount toward the satisfaction of such liability, and it is further

ORDERED AND DECREED that the defendant Richard H. Clayton pay over to Texas Gulf Sulphur Company the amount of 20,010.56, with interest at 6% from April 17, 1964, such (6933) amount to be held by Texas Gulf Sulphur Company in escrow in an interest bearing account for five years, subject to disposition in such manner as the Court may direct upon application by the Securities and Exchange Commission or other interested person or upon the Court's own motion, at the end of such period such amount as may remain to become the property of Texas Gulf Sulphur Company, except that if Richard H. Clayton or his estate shall incur liability to any person or entity by reason of his purchases of Texas Gulf Sulphur Company securities during the period November 12, 1963, through April 16, 1964, as a result of a judgment in or settlement of any other action, Texas Gulf Sulphur Company will, at the request of Richard H. Clayton or his estate, apply said amount toward the satisfaction of such liability, and it is further

ORDERED AND DECREED that defendant Harold B. Kline surrender to Texas Gulf Sulphur Company his stock option heretofore granted on February 20, 1964, covering 4,300 shares of stock, and that Texas Gulf Sulphur Company rescind and cancel such option, and it is further

ORDERED AND DECREED that this Court shall retain jurisdiction for the purpose of the carrying out of this judgment.

Dated: New York, New York
April 16, 1970.

Dudley B. Bonsal
U. S. D. J.

JUDGMENT ENTERED
4/16/70

John Livingston
Clerk

Appendix A

Second Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 914—September Term, 1970.

(Argued May 11, 1971 Decided June 10, 1971.)

Docket No. 35143

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Appellee,

v.

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, CLAUDE O. STEPHENS, EARL L. HUNTINGTON and HAROLD B. KLINE,
Defendants-Appellants.

Before:

FRIENDLY, *Chief Judge,*
and WATERMAN and HAYS, *Circuit Judges.*

WATERMAN, *Circuit Judge*:

The within appeals bring before us for the second time the well-known combinations of situations that arose out of Texas Gulf Sulphur's (hereinafter TGS) discovery of rich ore deposits near Timmins, Ontario, and the accompanying stock transactions by the appellants. A detailed description is set forth in our prior opinion, 401 F.2d 833

(2 Cir. 1968) (in banc).[1] In that decision we reversed the district court with reference to its findings, contained in its opinion, 258 F. Supp. 262 (SDNY 1966), as to several of the defendants who had been found below not to have violated Section 10(b) of the Securities Exchange Act of 1934 (hereinafter the Act), 15 U.S.C. §78j(b), and Rule 10b-5, 17 CFR 240.10b-5, promulgated thereunder, and we remanded the case for a hearing on the appropriate remedies to be applied[2] and for the resolution of one undecided question of liability. That hearing has been held, and varying sanctions have been applied. The judgment order entered below (1) enjoined defendants Clayton and Crawford from future violations of Rule 10b-5, (2) denied injunctions against TGS, and defendants Fogarty, Mollison, Stephens, Darke, Huntington, Holyk, and Kline although each was found to have violated 10b-5, (3) required Darke to pay to TGS the profits which he and his tippees made on TGS stock prior to April 17, 1964, (4) required Holyk, Huntington, and Clayton to pay to TGS the profits which each of them made on the TGS stock prior to April 17, 1964,[3] and (5) required Kline's stock option to be canceled. In deciding the issues presented on this appeal, we have grouped the issues for easier discussion.

1. A petition to our in banc court for rehearing was subsequently denied, and two petitions for certiorari, one filed by a party not now in the case, and one by a present appellant, Kline, were denied by the Supreme Court, 394 U.S. 976 (1969).

2. Pursuant to a stipulation by all parties entered into prior to the former appeal, the question of appropriate remedies was deferred for imposition by the district court pending a final determination in appellate courts or upon remand to the district court of whether the defendants or any of them had violated Section 10(b) and Rule 10b-5.

3. Another defendant, Thomas P. O'Neill, was also directed to make similar payments to the TGS escrow fund. This order was entered upon a default judgment, and no appeal has been taken by O'Neill.

A. *TGS—The April 12 press release.*

On April 12, 1964, TGS issued its now famous press release dispelling rumors about the results of its exploratory drilling at Timmins. In our prior opinion we found that this release satisfied all the elements of a violation of Rule 10b-5, with the exception that a hearing was needed in order to determine whether the release was "misleading to the reasonable investor," 401 F.2d at 863, and whether this was caused by a lack of due diligence. On demand Judge Bonsal received both live and deposition testimony from a series of former TGS shareholders who claimed to have sold their stock because of the contents of the April 12 press release. Counsel for TGS objected to this testimony as non-expert opinion testimony of the ultimate fact for decision by the trier of fact, that is, whether the release was misleading. When these objections were overruled, TGS presented its own string of witnesses who testified that in their opinion the release was optimistic and not misleading. On the basis of this contradictory testimony, Judge Bonsal found that the release was misleading to the reasonable investor and that it violated Rule 10b-5. Nevertheless, because there was no showing of any reasonable likelihood that TGS would violate Section 10(b) and Rule 10b-5 in the future, Judge Bonsal denied the SEC's request for an injunction against the corporation.

Upon appeal TGS first contends that the admission of non-expert opinion testimony as to whether the press release was misleading was error. We first note that, contrary to the TGS contention, this testimony did not go to the ultimate issue. The ultimate issue was whether the release was "misleading to the reasonable investor." The testimony of the SEC's witnesses was only that they individually had sold their stock on the basis of the April 12 press release. Cf. *Goldwater* v. *Ginzburg*, 414 F.2d 324, 343 (2 Cir. 1969),

cert. denied, 396 U.S. 1049 (1970). See also Rule 704, Proposed Rules of Evidence for United States Courts and Magistrates (March 1971). There is little doubt that the testimony offered by the SEC was relevant to whether the release was misleading to the "reasonable investor," but its relevance does not mean that the testimony itself was of the ultimate fact. Nor does the claim that the testimony was possibly opinion testimony render it inadmissible. All human perception includes elements of subjective conclusions, and the line between factual and opinion testimony is often undefinable. As stated by Judge Learned Hand in *United States* v. *Cotter,* 60 F.2d 689, 693-694 (2 Cir.), *cert. denied,* 287 U.S. 666 (1932):

> No rule is subject to greater abuse [than the opinion testimony rule]; it is frequently an obstacle to any intelligible account of what happens. Most witnesses will tell their story in colloquial speech which skips the foundations and runs in terms of the "ultimate facts." Ordinarily, they tell it much more plainly in this way, and the warrant for what they say can be perfectly probed by cross-examination.

See also *United States* v. *Petrone,* 185 F.2d 334, 336 (2 Cir. 1950), *cert. denied,* 340 U.S. 931 (1951). Of course, a foundation for opinion testimony must be laid, see Rule 701, Proposed Rules of Evidence for United States Courts and Magistrates (March 1971), and, without question, a foundation was laid here. In such cases, especially where there is no jury, the admission of this kind of testimony lies quite properly within the discretion of the trial court.

TGS also points to a number of facts which it claims makes the SEC's witnesses appear to be "unreasonable," instead of "reasonable," investors. However, these factors go only to the weight of the evidence and were thoroughly explored by TGS upon cross-examination. We conclude

that Judge Bonsal's findings of fact on this issue, after his careful and painstaking weighing of the conflicting testimony in the light of our prior opinion, are not clearly erroneous findings, and we hold, with him, that the press release of April 12 was indeed misleading to the reasonable investor.

TGS next contends that it exercised due diligence in issuing the April 12 press release. However, the district court found, on the basis of the standards laid down in our former opinion, that "the framers of the press release failed to exercise due diligence." 312 F. Supp. at 86. TGS urges that this finding was not an independent finding of fact but a mere adoption of the views in our previous opinion. On this issue TGS introduced no additional evidence on remand, and, without such additional testimony, the fact that the district judge's finding concurred with what TGS claims to have been the view of the in banc court in no way impeaches the independence of the district judge. We find nothing improper in the challenged finding of lack of due diligence.

TGS finally contends that the finding of a violation of Rule 10b-5 for mere negligence in the issuance of the April 12 press release infringes its First Amendment rights.[4] However, the First Amendment deals with the free exchange of ideas and not with commercial "factual" speech. *Valentine* v. *Chrestensen,* 316 U.S. 52 (1942); *Securities & Exch. Comm'n* v. *Wall Street Transcript Corp.,* 422 F.2d 1371, 1379-1381 (2 Cir.), *cert denied,* 398 U.S. 958 (1970); *New York State Broadcasters Ass'n* v. *United States,* 414 F.2d 990, 996-997 (2 Cir. 1969), *cert. denied,* 396 U.S. 1061 (1970); *Banzhaf* v. *FCC,* 405 F.2d 1082, 1101-1102 (D.C. Cir. 1968); *cert. denied sub nom. Tobacco Institute* v. *FCC,*

4. Inasmuch as this issue was not decided by our prior opinion, it is not foreclosed by that decision. It was raised initially in the petition for rehearing, and being bottomed upon an alleged infringement of a constitutional limitation is fully considered here.

396 U.S. 842 (1969); cf. *Curtis Publishing Co.* v. *Butts*, 388 U.S. 130, 150 & n. 14 (1967); *Garrison* v. *State of Louisiana*, 379 U.S. 64, 75 (1964). The April 12 release was a corporate report on the progress of TGS's drilling operations near Timmins, Ontario, and, insofar as the First Amendment's protection of speech is concerned, the report is in the same category as corporate registration statements and prospectuses.

The finding that TGS violated 10b-5 is well-founded and, in our view, unassailable, and though TGS argues that the complaint should be dismissed as to it inasmuch as the injunction the SEC sought was not granted, we affirm the denial of an injunction without dismissing the complaint as a proper discretionary decision by the trial judge under the circumstances. See *Sullivan* v. *Committee on Admissions & Grievances*, 395 F.2d 954 (D.C. Cir. 1969).

B. *Injunctions—Clayton and Crawford.*

Clayton and Crawford were the only defendants enjoined from committing future violations of Rule 10b-5.[5] They contend that this action was discriminatory, particularly because there was no evidence to indicate that their former violations might be repeated. Although we suspect that all the defendants will be circumspect in their future stock transactions, we find that, if any injunctions are to be issued, there is sufficient distinction in Clayton's and Crawford's cases for the district court to single them out. Both of these defendants, having inside information as to the results of the Timmins drilling, bought stock within 24 hours before the news of the ore strike was made public.

5. The injunctions were drawn to cover the circumstances of the violations and enjoined Clayton and Crawford from engaging in the future in any purchases or sales of TGS securities on the basis of undisclosed material information relating to TGS which is acquired by reason of any "insider" relationship with TGS.

Indeed, Clayton and Crawford were the only appellants who had been adjudged violators of Rule 10b-5 by the district court at the first trial of this case. Although the other defendants might have argued that they could not see the "development" of the law which resulted in their having been found by our court to have violated Rule 10b-5, Clayton's and Crawford's conduct was highly suspect even under the principles which the district court applied in its first decision. 258 F. Supp. 262, 285-287 (SDNY 1966).

Crawford again contends, as he contended before, that it was reasonable for him to believe that his stock purchases would be transacted after the public received the full news of the Timmins discovery. However, his present argument is precluded by our former decision which dealt fully with the issue which Crawford would have us now reconsider. 401 F.2d at 856.

In issuing the injunctions against Clayton and Crawford under these circumstances the district judge did not abuse his discretion. See *Securities & Exch. Comm'n* v. *Culpepper,* 270 F.2d 241, 250 (2 Cir. 1959).

C. *Restitution of Profits.*

The district court required Holyk, Huntington, Clayton, and Darke to pay to TGS the profits they had derived (and, in Darke's case, also the profits which his tippees had derived) from their TGS stock between their respective purchase dates and April 17, 1964, when the ore strike was fully known to the public. The payments are to be held in escrow in an interest-bearing account for a period of five years, subject to disposition in such manner as the court might direct upon application by the SEC or other interested person, or on the court's own motion. At the end of the five years any money remaining undisposed of would become the property of TGS. To protect the appellants against double liability, any private judgments against

these appellants arising out of the events of this case are to be paid from this fund.[6]

Appellants contend that, although the district court is given general equity powers under §27 of the Act, the SEC does not have authority under the Act to seek anything but injunctive relief under §21(e), together with whatever ancillary relief is necessary to enforce an injunction, such as the appointment of a receiver. They further contend that the payments required in this case are in essence penalties for they contain no element of compensation to those who may actually have been damaged, and that if it were appropriate to consider the assessment of penalties, it was necessary for the Attorney General to bring a criminal action under §32.

However, despite some legislative history purportedly to the contrary,[7] we do not read §21(e)[8] as restricting the remedies which the SEC can pursue to injunctive relief. The appellants concede that the courts of appeal have upheld the equity power of the district courts to authorize as ancillary relief the appointment of receivers under the Securities Exchange Act of 1934 at the request of the SEC even though no specific statutory authority exists for such action. *Securities & Exch. Comm'n* v. *Bowler*, 427 F.2d 190,

6. According to the district court's opinion, 312 F. Supp. at 93, the settlement orders are to be fashioned after that established with the defendant Coates who is not now an appellant. The relevant terms of the Coates settlement are set forth in footnote 23 of the district court's opinion.

7. S. Rep. 792, 73d Cong., 2d Sess., 1934, p. 22; H.R. Rep. 1383, 73d Cong., 2d Sess., 1934, p. 27.

8. §21(e) (15 U.S.C. §78u(e)) reads:
Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation . . . it may . . . bring an action . . . to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond.

197-198 (4 Cir. 1970); *Securities & Exch. Comm'n* v. *Bartlett,* 422 F.2d 475, 477-478 & n. 6 (8 Cir. 1970); *Lankenau* v. *Coggeshall & Hicks,* 350 F.2d 61 (2 Cir. 1965); *Esbitt* v. *Dutch-American Mercantile Corp.,* 335 F.2d 141, 143 (2 Cir. 1964); *Los Angeles Trust Deed & Mortgage Exchange* v. *Securities & Exch. Comm'n,* 285 F.2d 162, 181-182 (9 Cir. 1960).

Moreover, in other contexts the Supreme Court has upheld the power of the Government without specific statutory authority to seek restitution, and has upheld the lower courts in granting restitution, as an ancillary remedy in the exercise of the courts' general equity powers to afford complete relief. *Mitchell* v. *DeMario Jewelry,* 361 U.S. 288 (1960); *United States* v. *Moore,* 340 U.S. 616 (1951); *Porter* v. *Warner Holding Co.,* 328 U.S. 395 (1946). There is little doubt that §27 of the Act confers general equity power upon the district courts. Appellants' contention is that the SEC is without the authority to request the exercise of these powers. However, as stated in *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375, 391 (1970): "[W]e cannot fairly infer from the Securities Exchange Act of 1934 a purpose to circumscribe the courts' power to grant appropriate remedies." While *Mills* was dealing with relief to private litigants, we deem the above statement to be fully applicable in enforcement actions by the SEC. Thus, we hold that the SEC may seek other than injunctive relief in order to effectuate the purposes of the Act, so long as such relief is remedial relief and is not a penalty assessment.

Appellants, of course, contend that the required restitution is indeed a penalty assessment. See *Securities & Exchange Comm'n* v. *Beck,* 430 F.2d 673 (6 Cir. 1970). This contention overlooks the realities of the situation. In our prior opinion we found that these appellants had violated the Act by their purchases of TGS stocks before there had been a public disclosure of the ore discovery. Restitution

of the profits on these transactions merely deprives the appellants of the gains of their wrongful conduct. Nor does restitution impose a hardship in this case. The lowest purchase price of any of the transactions here was $17.75 per share paid by Clayton on November 15, 1963. The mean average price of the stock on April 17, 1964, has been stipulated by the parties to be $40.375 per share. By May 15, 1964, the stock was selling at $58.25 per share. The court's order requires only restitution of the profits made by the violators prior to general knowledge of the ore strike on April 17, 1964, and, in effect, leaves the appellants all the profits accrued after that date. It would severely defeat the purposes of the Act if a violator of Rule 10b-5 were allowed to retain the profits from his violation. The district court's order corrects this by effectively moving the purchase dates of the violators' purchases up to April 17, 1964.

As to the requirement that Darke make restitution for the profits derived by his tippees, admittedly more of a hardship is imposed. However, without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information. Either the transactions so traded could be concluded by a relative or an acquaintance of the insider, or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given.

Finally, appellants contend that the order is punitive because it contains no element of compensation to those who have been damaged. However, as the New York Court of Appeals in *Diamond* v. *Oreamuno*, 24 N. Y. 2d 494, 499, 301 N. Y. S. 2d 78, 81-82 (1969), recognized, a corporate enterprise may well suffer harm "when officers and directors abuse their position to obtain personal profits" since "the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities." Although the sellers of TGS stock who sold before April 17, 1964, may have a

higher equity than TGS to recover from appellants the wrongful profits appellants obtained, this fact does not preclude conditional compensation to TGS. Nor, as the appellants appear to imply, is the district court precluded from applying a state concept of harm to the corporation.

We conclude that the requirement of restitution in this case was a proper exercise by the trial judge of the district court's equity powers.

D. *Kline—cancellation of stock option.*

In our prior opinion we directed the district court to cancel Kline's stock option to rectify his violation of Rule 10b-5 (the other four stock options had been voluntarily canceled or were otherwise not in issue). 401 F.2d at 857. Although, as with the requirement of restitution considered above, the district court had the power to order the cancellation of the option so as to effect the purposes of the Act, we confess our error in instructing the district court without further proceedings there to apply this remedy inasmuch as the question of remedies was not before this court on the prior appeal. By stipulation of the parties, the question of appropriate remedies was deferred pending a final determination on whether Rule 10b-5 had been violated. See 401 F.2d at 839 n. 1. Hence, none of the parties argued or briefed the question of remedies on the last appeal. On remand, the district court, confronted with our unambiguous instruction, ordered the cancellation of Kline's stock option without holding a hearing on the issue. Thus, Kline has been deprived of his day in court on the question of an appropriate remedy, and we must remand Kline's case for a hearing on this question.

Kline also urges that his admittedly limited knowledge of the drilling results at the time he accepted the option was not material even under the definition of "materiality" we laid down in our prior decision. While we agree that Kline's lack of dealing in TGS stock would seem to support

his claim of limited knowledge, thus making the question an extremely close one factually, this issue was fully before the in banc court and no sufficient reason is advanced why this court's prior determination should be changed. However, Kline is not precluded from arguing the borderline nature of his violation upon remand insofar as it may bear on the question of the appropriate remedy to be applied to him.

E. *Crawford—The right to oral argument before an in banc court.*

Crawford urges that he was denied both his statutory rights and his constitutional right to procedural due process on the last appeal because oral arguments were not allowed before at least a quorum of the in banc court. In support of this contention Crawford relies heavily on 28 U.S.C. §46(c)[9] and the partial interpretation of that section given in *United States* v. *American-Foreign S.S. Corp.*, 363 U.S. 685 (1960), where it was held that the words "determined" and "active" were to be used in their literal sense in deciding the eligibility of court of appeals judges to sit in an in banc court. Crawford urges that the word "heard" should likewise be given a literal interpretation and, therefore, he claims that oral arguments are required before at least a quorum of the in banc court.

We point out that the Supreme Court cautioned at the very beginning of its opinion in *American-Foreign S.S. Corp.* that "[t]he question to be decided . . . is a narrow one." In concluding that only judges in "active service" were eligible to sit on in banc panels, it specifically referred to its earlier decision in *Western Pacific R. Corp.* v. *Western*

9. §46(c) reads:

> Cases and controversies shall be heard and determined by a court or division of not more than three judges, unless a hearing or rehearing before the court *in banc* is ordered by a majority of the circuit judges of the circuit who are in regular active service.

Pacific R. Co., 345 U.S. 247 (1953), as authoritative on the legislative history and intent of §46(c). Thus, because the present question of hearing procedure is different from the narrow question of judicial eligibility in *American-Foreign S.S. Corp., we turn to Western Pacific.*

As explained in *Western Pacific*, §46(c) was merely a ratification of the earlier decision in *Textile Mills Securities Corp.* v. *Commissioner*, 314 U.S. 326 (1943), in which the Supreme Court held that the courts of appeals had the power to hear cases in banc. As stated in *Western Pacific*:

> §46(c) is not addressed to litigants. It is addressed to the Court of Appeals. It is a grant of power. It vests in the court the power to order hearings en banc. It goes no further. 345 U.S. at 250.

Thus, §46(c) does not confer rights upon the litigants:

> The statute deals not with rights, but with power. . . . Because §46(c) is a grant of power, and nothing more, each Court of Appeals is vested with a wide latitude of discretion to decide for itself just how that power shall be exercised. 345 U.S. at 259.

American-Foreign S.S. Corp., upon which Crawford relies, concerned solely a question of "power," the eligibility of a circuit judge not in active service to sit on an in banc panel. In marked contrast to this, when the Supreme Court was faced with a procedural interpretation of §46(c) in *Shenker* v. *Baltimore & Ohio R.R. Co.*, 374 U.S. 1 (1963), it gave broad leeway to the Court of Appeals to render its own interpretation of the word "majority" in §46(c). It specifically referred to the problem as one of "internal administration." 374 U.S. at 5.

Because §46(c) pertains only to our power to convene in banc panels, we do not interpret it as requiring that a convened in banc court must listen to oral arguments. The decision to grant or not grant oral arguments on cases in

banc is purely a matter of discretion, and the court may limit the issues to be presented to it and the method of advancing the arguments to it.

Crawford also contends that the lack of oral arguments before the in banc court deprived him of due process under the Fifth Amendment. As to this contention, it seems obvious that the power to deny a rehearing clearly encompasses the power to limit a rehearing so long as the parties are treated equally. We find no merit to this claim.[10]

F. *Fogarty, Mollison and Stephens.*

The trial court on remand found that under the circumstances no relief needed to be ordered against these three defendants. Because no relief was granted, these defendants urge that the complaint should have been dismissed as to them and the recitation of their violations of the Act stricken from the judgment. We disagree. Because of the nature of the violations, it was within the district court's discretion to deny injunctive relief without dismissing the complaint. See *Sullivan* v. *Committee on Admissions and Grievances,* 395 F.2d 954 (D.C. Cir. 1969).

G. *Conclusion.*

In summary, therefore, we affirm the judgment below as to each of the appellants, with the exception that the order cancelling Kline's stock option is reversed and his case is remanded for a hearing on the appropriateness of that remedy.

---

10. We also note that the Fifth Circuit has exercised a discretion to dispose of oral arguments at the original "hearing" before three-judge panels. Rule 18, 5 Cir.; see *Isbell Enterprises, Inc.* v. *Citizens Casualty Co. of New York,* 431 F.2d 409, 410-414 (5 Cir. 1970). Inasmuch as the validity of this practice is not now before us, we do not intend that anything stated in the present opinion be construed as approving or disapproving the denial of oral arguments at the initial "hearing" on appeal, despite the existence of authority in support of such a practice. See *FCC* v. *WJR,* 337 U.S. 265, 276 (1949); Davis, Administrative Law §7.07 at 434.

Appendix A

Judgment of the United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE

SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of June, one thousand nine hundred and seventy-one.

Present:

HON. HENRY J. FRIENDLY, *Chief Judge,*
HON. STERRY R. WATERMAN,
HON. PAUL R. HAYS, *Circuit Judges.*

[SAME TITLE]

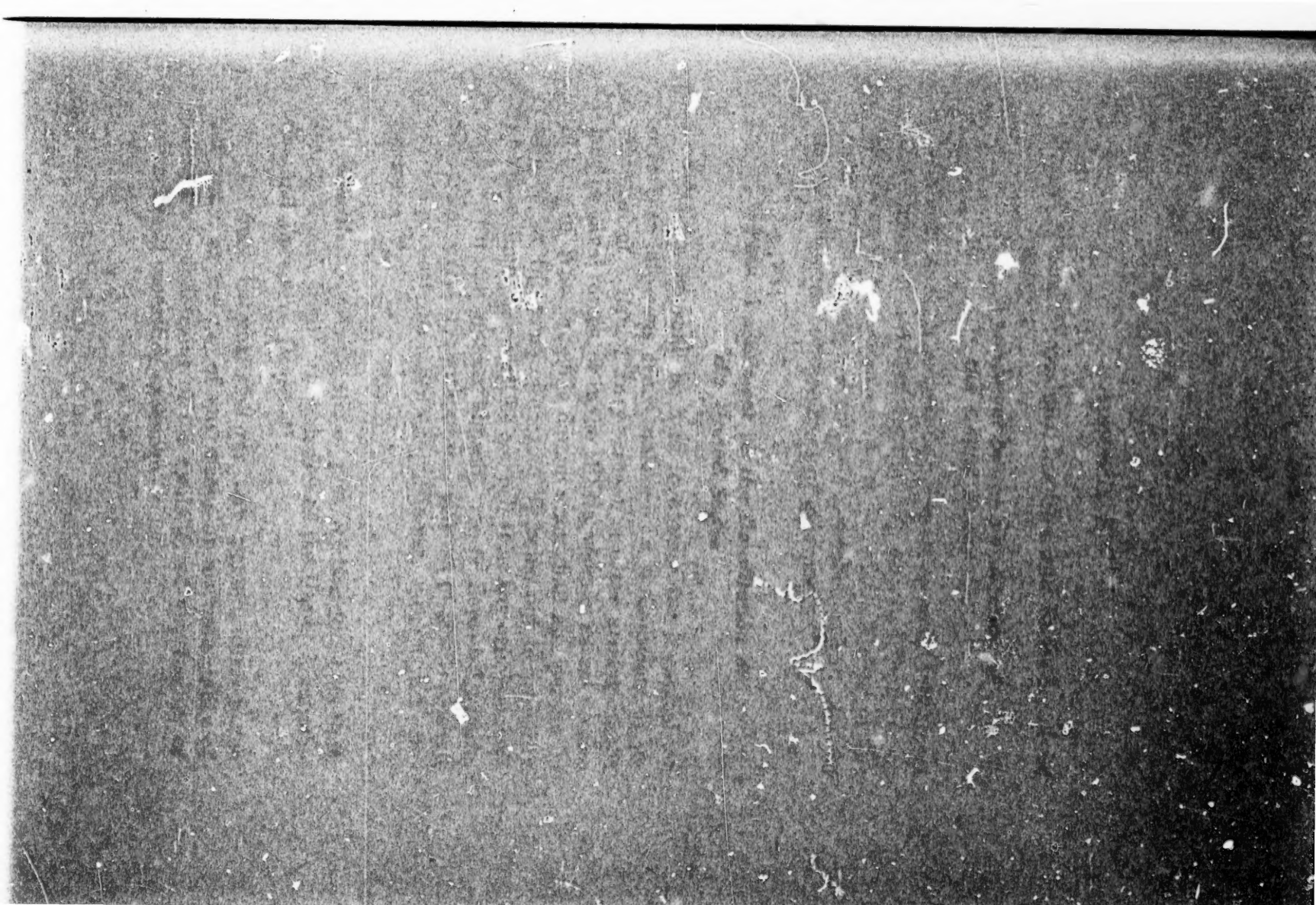
Appeal from the United States District Court for the Southern District of New York.

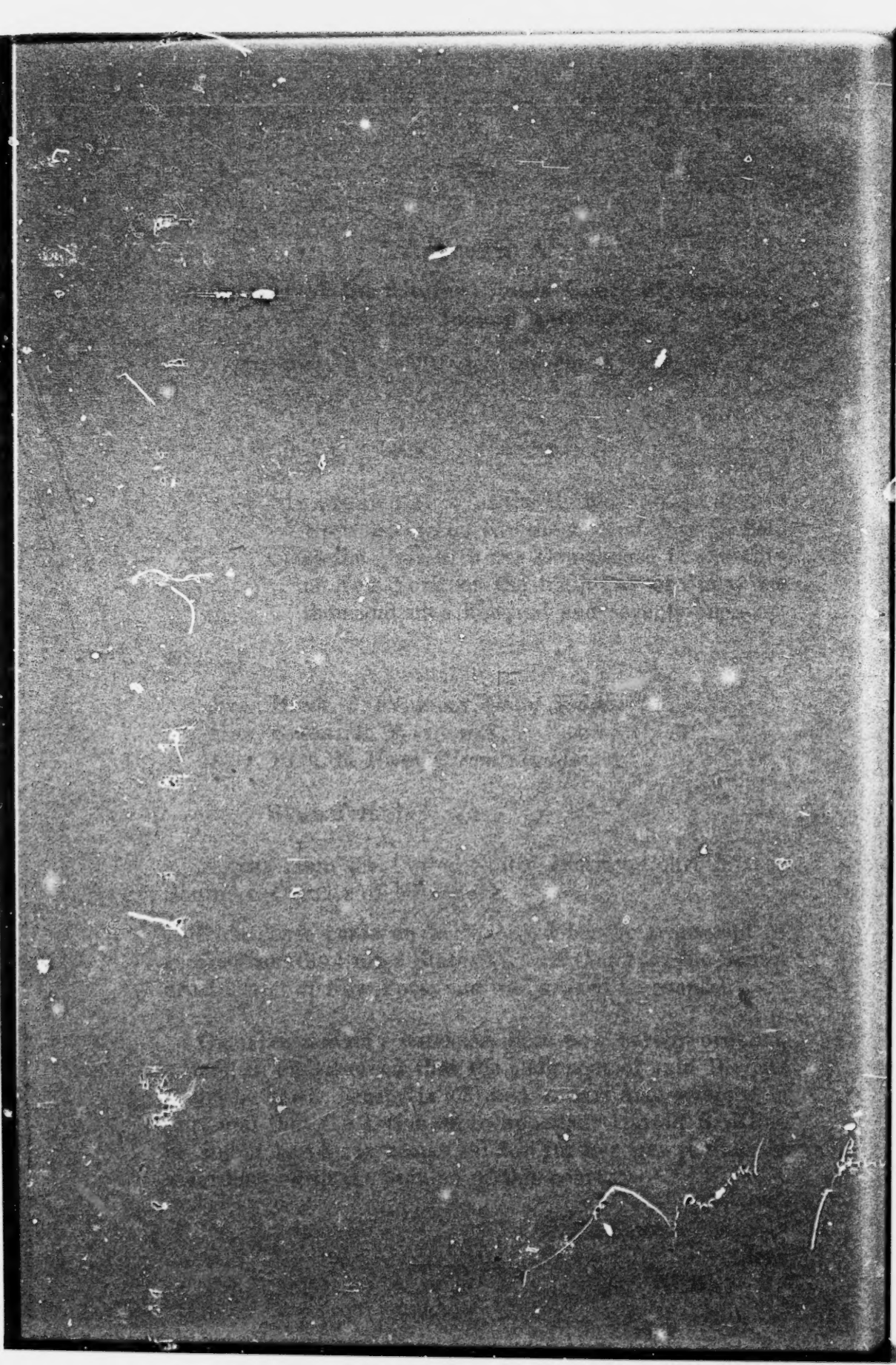
This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in part and reversed in part and that the action as to appellant Harold B. Kline be and it hereby is remanded for further proceedings in accordance with the opinion of this court.

A. DANIEL FUSARO
Clerk

/s/ W.B.





Appendix B

Constitutional Provisions, Statutes and Rules Involved

FIRST
~~Fifth~~ *Amendment to the Constitution of the United States*

"Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble, and to petition the Government for a redress of grievances."

FIFTH
~~First~~ *Amendment to the Constitution of the United States*

"No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offence to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.'

Securities Exchange Act of 1934, Section 10(b), 48 Stat. 891, 15 U.S.C. §78j: "Regulation of the Use of Manipulative and Deceptive Devices":

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

• • •

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Securities Exchange Act of 1934, Section 21(e), 48 Stat. 900, 15 U.S.C. §78u(e): "Investigations; Injunctions and Prosecution of Offenses":

"(e) Whenever it shall appear to the Commission that any person is engaged or about to engage in any acts or practices which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder, it may in its discretion bring an action in the proper district court of the United States, the District Court of the United States for the District of Columbia, or the United States courts of any Territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. The Commission may transmit such evidence as may be available concerning such acts or practices to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title."

Securities Exchange Act of 1934, Section 27, 48 Stat. 902, 15 U.S.C. §78aa: "Jurisdiction of Offenses and Suits":

"Sec. 27. The district courts of the United States, the District Court of the United States for the District of

Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code as amended (U.S.C. title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts."

Securities Exchange Act of 1934, Section 32(a), 48 Stat. 904, 15 U.S.C. §78ff: "Penalties":

"Sec. 32. (a) Any person who willfully violates any provision of this title, or any rule or regulation thereunder the violation of which is made unlawful or the observance of which is required under the terms of this title, or any person who willfully and knowingly makes, or causes to be made, any statements in any application, report, or document required to be filed under this title or any rule or regulation thereunder or any undertaking contained in a

registration statement as provided in subsection (d) of section 15 of this title, which statement was false or misleading with respect to any material fact, shall upon conviction be fined not more than $10,000, or imprisoned not more than two years, or both, except that when such person is an exchange, a fine not exceeding $500,000 may be imposed; but no person shall be subject to imprisonment under this section for the violation of any rule or regulation if he proves that he had no knowledge of such rule or regulation."

Rule 10b-5, 17 C.F.R. 240.10b-5: "Employment of Manipulative and Deceptive Devices":

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Rule 12b-2(j), 17 C.F.R. 240.12b-2(j): "Definitions":

"Unless the context otherwise requires, the following terms, when used in the rules contained in this regulation or in Regulation 13A or 15D or in the forms for statements and reports filed pursuant to sections 12, 13 or 15(d) of this act, shall have the respective meanings indicated in this rule:

• • •

(j) *Material.* The term 'material,' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered."

SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
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IN THE

Supreme Court of the United States

October Term, 1971

Docket No. 71-327

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, ~~RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD,~~ CLAUDE O. STEPHENS, ~~EARL L. HUNTINGTON~~ and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
With Respect to the Corporate Petitioner	2
With Respect to Individual Petitioners	4
With Respect to All Petitioners	5
Constitutional Provisions, Statutes and Rules Involved	5
Statement of the Case	6
A. Introductory Statement	6
B. The Charges Against Petitioners	7
C. The Facts as Developed at Trial	8
1. The Initial Drill Hole	8
2. The Subsequent Drilling	9
3. The Press Release of Sunday, April 12, 1964	10
D. The Decisions Below (The *First* Round)	11
1. Concerning the Individual Petitioners	11
2. Concerning Texas Gulf Sulphur Company	13
E. The Decisions Below (The *Second* Round)	15
1. The District Court	15
2. The Court of Appeals	17
Reasons for Allowance of the Writ	17

PAGE

Argument

I. This case raises fundamental and far reaching questions of administration of the securities laws and the proper roles of Congress, the Commission, and the federal courts 19

II. The holding below, which runs counter to a basic purpose of the securities laws, counter to the expressed intent of Congress and contrary to precedent, presents to this Court fundamental questions of importance under the securities laws concerning corporate and public information practices 22

III. The imposition of liability for negligent misstatement under Rule 10b-5 upon a well-intentioned company responding to false and exaggerated rumors and commenting on its affairs in the form of a press release presents to this Court an important question of freedom of speech 27

IV. The Second Circuit adopted a test of materiality in conflict with regulations adopted by the Commission, with decisions of the Seventh and Tenth Circuits, and with its own previous decisions 30

V. It is not unlawful for a corporate employee to purchase his company's stock or to accept stock options in the absence of a showing of fraud and deceit 33

VI. The Court of Appeals completely disregarded Rule 52(a) in (1) reaching geological, geophysical and investment conclusions which were contrary to findings of the trial court and without support in the record and (2) in implicitly overruling Judge Bonsal's finding that Texas Gulf officers had "exercised reasonable business judgment" (*i.e.*, acted with due diligence) in issuing the April 12 release 36

PAGE

VII. The decisions of the courts below violate petitioners' constitutional rights under the Fifth Amendment and well-settled principles of administrative procedure 38

VIII. Whether the SEC, in an enforcement proceeding under Section 21(e) of the 1934 Act, may seek a remedy which requires a stock option to be rescinded, is an issue as yet undecided by this Court and as to which a conflict exists between the Second and Ninth Circuits 40

IX. The Court below erroneously denied to petitioners an opportunity for oral argument of the issues before a quorum of the Court sitting *en banc* 41

Conclusion 42

Addendum ..... Add. 1

Appendix—(Opinions and Judgments of Court of Appeals and District Court, Separately Bound)

TABLE OF AUTHORITIES

PAGE

Cases:

Blau v. Lehman, 368 U.S. 403 (1962) 39
Blau v. Max Factor & Co., 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965) 34
Boyce Motor Lines, Inc. v. United States, 342 U.S. 337 (1952) 38

Cannon v. Texas Gulf Sulphur Co., 47 F.R.D. 60 (S.D. N.Y. 1969) 21

Graver Tank & Mfg. Co. Inc. v. Linde Air Prods. Co., 339 U.S. 605 (1950) 37
Greene v. Dietz, 247 F.2d 689 (2d Cir. 1957) 34

In re Calton Crescent, Inc., 173 F.2d 944 (2d Cir.), *aff'd sub nom.* Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949) 34

James Blackstone Memorial Library Ass'n. v. Gulf, M. & O. R.R., 264 F.2d 445 (7th Cir.), *cert. denied,* 361 U.S. 815 (1959) 31

List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied sub nom.,* List v. Lerner, 382 U.S. 811 (1965) 31

McBoyle v. United States, 283 U.S. 25 (1931) 38
M. Kraus & Bros. Inc. v. United States, 327 U.S. 614 (1946) 38
Morris v. Burchard, 51 F.R.D. 530 (S.D.N.Y. 1971) 22

New York Times v. Sullivan, 376 U.S. 254 (1964) 29

Reynolds v. Texas Gulf Sulphur Co., CCH Fed. Sec. L. Rep. ¶93,019 (10th Cir. 1971) 6, 21
Rosenbloom v. Metromedia, 91 S. Ct. 1811 (1971) 29–30

PAGE

SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) 21
SEC v. National Securities, Inc., 393 U.S. 453 (1969) 41
Sunray DX Oil Co. v. Helmerich & Payne, Inc., 398 F.2d 447 (10th Cir. 1968) 26n, 32

Thornhill v. Alabama, 310 U.S. 88 (1940) 29

United States v. Parkinson, 240 F.2d 918 (1956) 41

Constitutional Provisions, Statutes and Rules:

Federal Rule of Civil Procedure 23 21

Federal Rule of Civil Procedure 52(a) 13, 14, 19, 36, 37

First Amendment to the Constitution of the United States 18, 29, 30

Fifth Amendment to the Constitution of the United States 38

Investment Company Act of 1940 (15 U.S.C. §80a-1) 30n

Securities Act of 1933 (15 U.S.C. §77a, *et seq.*):

Section 17 .....20, 23

Securities Exchange Act of 1934 (15 U.S.C. §78, *et seq.*):

Section 9 22
Section 10(a) 22
Section 10(b) .....*passim*
Section 12 24
Section 14 24
Section 16 .....25, 34
Section 18 25
Section 21(e) 8, 40, 41
Section 27 ..... 8, 40
Section 32 .....25, 41

PAGE

SEC Rules and Regulations:

Regulation C, Rule 405 (17 C.F.R. §230.405(1)) 30n
Regulation S-X, Rule 1-02(g) (17 C.F.R. §210.1-02(g)) 30n
Rule 8b-2 (17 C.F.R. §270.8b-2) 30n
Rule 10b-5 (17 C.F.R. §240.10b-5) ..... *passim*
Rule 10b-6 (17 C.F.R. §240.10b-6) 20
Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) 30n

Other Authorities:

BROMBERG, *Securities Law: Fraud*—SEC Rule 10b-5 31

Cohen, Milton, *"Truth in Securities" Revisited*, 79 Harv. L. Rev. 1340 (1966) 25

Freeman, 22 Bus. Law. 922 (1967) 23n

Hearings on H.R. 7852 and H.R. 8720 before The House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934) 22, 33-34

Hearings on H.R. 4344, H.R. 5065 and H.R. 5832 before The House Committee on Interstate and Foreign Commerce, 77th Cong., 1st Sess. (1941) 34

H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) 25

H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) 33

Item 8(A) (b), 1 CCH Fed. Sec. L. Rep. ¶7327 ..... 26n

Loss, *History of S.E.C. Legislative Programs and Suggestions for A Code*, 22 Bus. Law. 795 (1967) 20

Loss, *Securities Regulation* (1961) 20, 35

Note, *Impact of Class Actions on Rule 10b-5*, 38 U. Chi. L. Rev. (Winter, 1971) 21–22

SEC Petition for Rehearing, Greene v. Dietz, 247 F. 2d 689 (2d Cir. 1957), CCH Fed. Sec. L. Rep. ¶90,821 (1957) 34

SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942) 23n

IN THE

Supreme Court of the United States

October Term, 1971

Docket No. .....

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, RICHARD H. CLAYTON, WALTER HOLYK, KENNETH H. DARKE, DAVID M. CRAWFORD, CLAUDE O. STEPHENS, EARL L. HUNTINGTON and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable Warren E. Burger, Chief Justice, and the Honorable Associate Justices of the Supreme Court of the United States:

Your petitioners herein, Texas Gulf Sulphur Company, Charles F. Fogarty, Richard D. Mollison, Claude O. Stephens and Harold B. Kline, respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on December 9, 1968 and June 10, 1971.

Opinions Below

The six opinions filed in 1968 by the Court of Appeals, *en banc,* are reported at 401 F.2d 833 and at p. 66a*; the 1971 opinion, not yet officially reported, appears at p. 220a. The first opinion of the District Court for the Southern District of New York (Bonsal, J.) is found at 258 F.Supp. 262 (1a) and the second opinion, after remand by the Court of Appeals, is found at 312 F.Supp. 77 (175a).

Jurisdiction

The judgments of the Court of Appeals for the Second Circuit were entered on December 9, 1968 and June 10, 1971, respectively, and this petition for certiorari was filed within ninety days of the latter date. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

Questions Presented

With Respect to the Corporate Petitioner:

1. Whether Rule 10b-5, promulgated by the SEC under Sec. 10(b) of the Securities Exchange Act of 1934 (prohibiting the employment of "Manipulative and Deceptive Devices" in the purchase or sale of securities), is a valid basis for constructing, through the judicial process, a code of federal common law governing corporate information practices, swallowing up specific statutes in the securities laws regulating this subject, and in particular:

(a) Whether a press release, issued by a corporation in response to false and exaggerated rumors

* References in this form are to the separately bound Appendix to this petition.

regarding its operations, was issued "in connection with" the purchase or sale of securities (and thus within the alleged ambit of Rule 10b-5), when neither the corporation nor the draftsmen of the release were in the market to buy or sell the corporation's securities or attempting to influence the market;

(b) Whether Rule 10b-5 imposes an affirmative duty upon a corporation, speaking voluntarily and with laudable motives with respect to its exploration activities, to set forth all "basic facts" known to it, rather than to express the good faith judgment of its principal officers that no definite conclusions as to the importance of a prospect could be made until further drilling was completed, promising a second statement as soon as responsible conclusions could be drawn;

(c) Whether a finding of violation should be sustained without the slightest evidence that the corporation, or its principal officers, acted in bad faith or with knowledge of falsity, or recklessly, in drafting and issuing the press release;

(d) Whether, in an enforcement proceeding for injunctive relief, the standard for judging the character of a press release should be the subjective test of whether some persons read the release as suggesting that a sale of stock was advisable, rather than an objective appraisal by the equity judge of whether its phrasing was misleading in the light of the facts known to the draftsmen at the time of its issuance?

2. Whether freedom of speech has been abridged by a holding that a corporation, in commenting on matters of public importance with respect to its operations, may vio-

late Rule 10b-5 if it allegedly speaks negligently, even when the evidence shows that the release was issued in good faith, for a laudable purpose, and was not designed to bring economic or commercial benefit to either the corporation or the draftsmen?

With Respect to the Individual Petitioners:

3. Whether Section 10(b) and Rule 10b-5, which prohibit fraudulent practices in connection with the purchase or sale of securities, forbid investment in corporate securities by corporate personnel through the facilities of a national securities exchange when such personnel possess unpublished information which would not be significant to the average prudent investor and would not have a substantial impact on the market price of the securities?

4. Whether information should be deemed "material" within the meaning of Rule 10b-5 if it "may" affect the desire of "speculators and chartists of Wall and Bay Streets" to buy, sell or hold corporate stock and "might" have an effect on the market price of the stock, even though the information would not be "material," as specifically defined in SEC regulations, in a prospectus or a registration statement, since it would not be significant to the average prudent investor and would not have a substantial impact on the market price?

5. Whether Section 10(b) and Rule 10b-5 impose a duty upon recipients of stock options, granted without inducement on their part, to relate to a corporate Board of Directors or Stock Option Committee, without its request or expectation, information concerning the company, even though such information would not be significant to the

average prudent investor and would not have a substantial impact on the market price of the company's stock?

6. Whether the SEC, under its statutory authority to seek injunctions in the federal courts, may obtain remedies in the form of monetary forfeitures?

With Respect to All Petitioners:

7. Whether it was error for the Court of Appeals to disregard Rule 52(a) in (1) reaching geological and geophysical conclusions as to the significance of the exploratory drilling which were contrary to findings of the trial court and (2) implicitly overruling Judge Bonsal's finding that the Texas Gulf officers had exercised reasonable business judgment (*i.e.* due diligence) in issuing the release?

8. Whether Rule 10b-5, as construed and applied below, gave "fair warning" to petitioners that their conduct would be held unlawful, as required by the Fifth Amendment to the United States Constitution and basic principles of administrative procedure?

9. Whether the court below properly denied to petitioners an opportunity for oral argument of the issues before a quorum of the court sitting *en banc* in 1968?

Constitutional Provisions, Statutes and Rules Involved

Constitution of the United States, Amendment I and Amendment V, are set forth at page 235a of Appendix B.

48 Stat. 891, 899, 902, 904; 15 U.S.C. §§78j(b), 78u(e), 78aa, 78ff, are set forth at pp. 235a to 238a of Appendix B.

17 C.F.R. §§240.10b-5 and 240.12b-2(j) are set forth at pp. 238a and 239a of Appendix B.

Statement of the Case

A. Introductory Statement

This is a case of seminal importance* in the interpretation of the federal securities laws and in the development of what has been termed "a federal common law of corporations" under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Indeed, the SEC, in opposing at an earlier stage the grant of certiorari with respect to two petitioning individual defendants, acknowledged the wide reaching significance of the case. (Brief for the Securities and Exchange Commission in Opposition to Petition for a Writ of Certiorari, in Nos. 897 and 937 (October Term, 1968), p. 25 (No. 897) and p. 23 (No. 937).) The decisions below are now substantially final and all aspects of this celebrated case are ripe for review.**

In addition, the companion petition† of Texas Gulf and Fogarty in *Mitchell* and *Reynolds* v. *Texas Gulf Sulphur Co.*, not yet officially reported (CCH Fed. Sec. L. Rep. ¶93,019 at 90,752 [10th Cir. 1971]), raise the further question of the standards governing private actions under Rule 10b-5; the decisions in that Tenth Circuit case, based on the initial decision of the Second Circuit herein, graphically

* Attached to this petition as an addendum is a partial bibliography indicating the widespread public concern over the issues now presented to this Court.

** Mr. Justice White, dissenting, was of the opinion that the issues presented by the petition filed by petitioner Kline in 1969 were sufficiently final to warrant review at that time (394 U.S. 976).

† The petition will be filed as soon as the Tenth Circuit has passed on a motion for rehearing filed by plaintiffs Mitchell and Reynolds on May 10, 1971.

demonstrate how the meaning and purpose of Rule 10b-5 have been expanded so as to supplant the limitations carefully imposed by Congress on private recovery under the securities laws, with results that run counter to the primary purpose of those laws.

B. The Charges Against Petitioners

Respondent instituted this action against petitioners and others on April 19, 1965, alleging *inter alia,* that petitioner Texas Gulf Sulphur Company (hereinafter "Texas Gulf") issued a press release on April 12, 1964 in response to rumors concerning its exploration for minerals in Canada, which was "known * * * to be materially false and misleading" in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. §78j(b), and of Rule 10b-5, 17 C.F.R. §240.10b-5 promulgated thereunder.

It was also alleged that petitioners Fogarty, Executive Vice President and a Director of Texas Gulf, and Mollison, Vice President, had purchased stock of Texas Gulf during the period from November 7, 1963 to just prior to April 12, 1964, while in possession of "material facts" concerning the result of "Texas Gulf's drilling" in the course of that exploration program, in violation of the same statute and rule. In addition, it was charged that Fogarty, Mollison, Stephens (President and a Director of Texas Gulf) and petitioner Kline, Vice President and General Counsel, had accepted stock options on February 20, 1964, in violation of the statute and rule because the members of the Stock Option Committee were unaware of the drilling results when the options were awarded.

Respondent sought an injunction under Section 21(e) of the 1934 Act against all defendants and additional relief which included rescission of the stock purchases and stock options by the individual defendants. Jurisdiction of the District Court was invoked under Section 27 of the 1934 Act, 15 U.S.C. §78aa. All parties waived a trial by jury and agreed that trial should first proceed on the question of violation alone.

C. The Facts as Developed at Trial

1. The Initial Drill Hole

In 1957, Texas Gulf initiated an exploration program in the geological area known as the Canadian Shield. Aerial geophysical surveys in 1959 over more than 15,000 miles indicated the presence of several hundred anomalies (areas of abnormal electrical conductivity) worthy of further investigation. On June 6, 1963, Texas Gulf acquired an option to purchase a 160 acre half lot near Timmins, Ontario, upon which one of the anomalies, known as Kidd-55, was thought in part to be located.

After conducting a ground geophysical survey, Texas Gulf proceeded with exploratory drilling. On November 8, 1963 the first drill hole (K-55-1) was begun near the corner of the lot Texas Gulf had acquired, and drilling of this 1⅛" diameter core was completed to a length of 655 feet on November 12, 1963. After examining this core, which contained encouraging showings of zinc and copper mineralization in varying amounts, Texas Gulf decided to try to acquire additional properties, since the core was drilled in a corner of the lot, and meanwhile to cease further drilling.

It was after this drill hole had been completed, and before further significant exploration had occurred, that petitioners Fogarty and Mollison purchased, respectively, 3100 and 300 shares of stock in Texas Gulf Sulphur Company. And before further drilling occurred, Texas Gulf's Stock Option Committee met at the call of its Chairman, who knew nothing about the drilling, and awarded qualified stock options to 26 officers and employees, including petitioners Stephens, Fogarty and Kline.

Stephens, Fogarty and Mollison were aware of the drilling results throughout this period. Kline, who was a lawyer and not a geologist, had only heard at a casual luncheon conversation that sulphides had been intersected near Timmins and that additional land acquisition would be attempted prior to further drilling.

2. *The Subsequent Drilling*

On March 31, 1964, Texas Gulf had sufficiently progressed with the acquisition of additional land to move more drill rigs into the area, and it resumed drilling. Between March 31 and 7:00 p.m. on April 9, drill cores had been obtained from two additional holes. The trial court concluded on the facts and the expert testimony that by April 9 at 7:00 p.m. "there was real evidence that a body of commercially mineable ore *might* exist" (28a-29a, emphasis supplied). However, the court also found that prior to this time the drilling results did not warrant such a conclusion (29a).

3. The Press Release of Sunday, April 12, 1964

The movement of four drill rigs to the site late in March and the commencing of additional drilling had generated rumors. These rumors intensified and on April 9, 1964, newspapers in Toronto reported discovery of "a major copper strike" and "one of the largest copper deposits in North America" (52a). On Saturday, April 11, both the *New York Times* and the *New York Herald Tribune* carried even more extravagant reports of Texas Gulf's drilling, describing it, *inter alia,* as "the biggest ore strike since gold was discovered more than 60 years ago in Canada" (52a). A quantity of false statistics appeared in the press, the company was accused of illegal conduct, and it was erroneously reported that a "penny stock" mining company was a partner with Texas Gulf in the exploration.

At this point, President Stephens, having consulted with the senior director of Texas Gulf, determined that Texas Gulf should issue a release to comment on the rumors. That release was drafted, on Stephens' instruction, by Fogarty after lengthy consultations on Saturday and Sunday with Mollison, who had been at Kidd-55 on Friday, April 10, and with Texas Gulf's public relations consultant. Before its release early Sunday afternoon it was cleared with a Texas Gulf attorney and read to President Stephens. The press release,* as issued, warned against accepting the extravagant rumors as fact, confirmed that Texas Gulf was drilling near Timmins, denied that it had a partner in the operation, stated that the drilling had "led to preliminary indications that more drilling would

* The press release is quoted in full in Judge Bonsal's second opinion (177a).

be required for proper evaluation of this prospect" (51a), and promised a further statement "when we have progressed to the point where reasonable and logical conclusions can be made" (51a).

D. The Decisions Below (The *First* Round)

1. Concerning the Individual Petitioners

During the four week trial, extensive evidence was introduced with respect to all aspects of the exploratory drilling and the significance of the first drill hole. This evidence included evaluations of geological and geophysical data, detailed logs of the drill hole, assay reports, examinations of the core itself, and testimony as to the significance of the drilling results to the value of Texas Gulf stock. In addition to Texas Gulf personnel, nine geologists, geophysicists or mining engineers and two security analysts testified. Numerous technical exhibits and demonstrative charts were considered by the trial judge.

On the evidence presented by both sides, the District Court concluded that "there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body" (29a) and that therefore the results of the first drill core "were too 'remote' when considered in light of the size of TGS, the scope of its activities and the number of its outstanding shares [10,000,000], to have had any significant impact on the market, *i.e.*, to be deemed material" (30a). The District Court further found that "[t]he fact that subsequent drilling established a major ore body is immaterial" (33a). It thus held that the purchases by Fogarty and Mollison were not unlawful (34a).

For the same reasons, the District Court held that none of the petitioners was under a duty to disclose the preliminary drilling results to the Stock Option Committee (48a), and that none had violated Rule 10b-5 in accepting options from the company (49a). In addition, the District Court found that that Committee "relied on information furnished it by the higher echelons of TGS's management" (47a); and that it "did not inquire of the recipients what special knowledge they might have as to various phases of TGS's business as it was entitled to rely on the information furnished by the management" (47a). Mollison and Kline were held not to constitute "top management,"* and thus were under no duty to volunteer to the Stock Option Commitee information known to their superiors. As to Mr. Kline, the District Court held that he "knew no details" (48a), and unlike the other petitioners, did not know of the situation at Timmins as it existed at the time (49a).

The Second Circuit reversed the findings with respect to materiality. It substituted its own geological and geophysical conclusions, stating that the initial drill core indicated a "more than marginal" possibility of the existence of a mine of "vast magnitude" (89a). Departing from precedent and SEC regulations, it asserted that "material" facts are any "which may affect the desire of investors to buy, sell or hold the company's securities" (88a), and defined "investors" to include "the speculators and chartists of Wall and Bay Streets" (87a). The court concluded that the results of the first drill hole, if disclosed, "may" have affected the desires of such persons, and "might" have affected stock prices and, therefore, that the statute and rule prohibited all stock transactions by in-

* The SEC did not appeal this determination as to Mollison.

formed persons after the drilling of the first hole. It thus reversed, in disregard of Rule 52(a), the trial court's findings and held that Fogarty and Mollison had violated Rule 10b-5 by their stock purchases, and that Stephens, Fogarty and Kline were in violation because of their acceptance of stock options. As to Kline, the court reversed the finding that he was not a member of "top management," and held that he, too, had been under a duty to disclose the little he knew regarding the exploration before accepting an option. The case was remanded to the District Court for consideration of remedies.*

2. *Concerning Texas Gulf Sulphur Company*

Judge Bonsal concluded, first, that the press release had not been issued "in connection with the purchase or sale of any security" and, therefore, that Rule 10b-5 was not applicable (54a). In addition, on the basis of the extensive expert testimony and other evidence, the District Court concluded that the SEC had "failed to demonstrate that it [the April 12 press release] was false, misleading or deceptive" (54a). He apparently agreed with defendants' experts that the release "accurately set forth the situation as it was known at the time" (56a) and found that the procedures followed by Texas Gulf in preparing the release were in accord with "reasonable business judgment under the circumstances" (58a). Moreover, the District Court concluded:

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* As to Kline, the Court of Appeals directed cancellation and rescission of his stock option. On the second appeal, it confessed its error in this respect and ordered a hearing on remedy to be held in the District Court (230a). The District Court, in a decision dated September 1, 1971, ordered Kline, in the event that he exercises his option, to pay over to Texas Gulf, in escrow subject to further order of the Court, the difference between the option price and the price of Texas Gulf stock on April 17, 1964.

> "it is apparent that the purpose of the April 12 press release was an attempt to meet the rumors which were circulating with respect to the Kidd 55 segment. There is no evidence that TGS derived any direct benefit from the issuance of the press release or that any of the defendants who participated in its preparation used it to their personal advantage. The issuance of the release produced no unusual market action." (54a)

The Court of Appeals reversed, again as we claim, in disregard of Rule 52(a), and announced an unprecedented rule of strict liability with respect to corporate press releases:

> "Rule 10b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public * * * if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." (113a)

It further held that the District Court, by measuring the April 12 press release objectively, *i.e.*, against the geological, geophysical and investment conclusions of the expert witnesses, had applied the wrong standard; the case was remanded to the District Court for a new determination "applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it" (115a). Should that issue be determined adversely to Texas Gulf, the District Court was instructed to determine "whether its issuance resulted from a lack of due diligence" (115a).

The Court of Appeals enunciated an *ex post facto* rule of corporate disclosure, *i.e.*, that a company, faced with extravagant and false rumors regarding its activities, must

not put out a preliminary "wait and see" statement, but should either obtain and publish all current reports of drilling, if possible, or delay publication of the release (116a-117a). Whatever the merits of this new rule, it had never before been enunciated or hinted at in the context of Rule 10b-5, which prohibits fraud and deceit in the purchase or sale of securities through the use of "manipulative or deceptive devices."

The majority opinion of Judge Waterman evoked strong dissent by two members of the Second Circuit (Chief Judge Lumbard and Judge Moore) and separate statements from four of the other judges. In his concurring opinion, Judge Friendly expressed his fears that the majority opinion would have serious repercussions. After noting that "no one has asserted, or reasonably could assert, that the purpose for issuing a release was anything but good" (121a), he went on to point out that if private damages were to be permitted in a case like this (as has subsequently happened), it could well result in the drying-up of corporate publicity (123a).

E. The Decisions Below (The *Second* Round)

1. The District Court

On remand, the District Court interpreted the Second Circuit's opinion with respect to the press release as calling for the application of a subjective test of investor reaction. Consequently, the remand proceeding consisted of a parade of investor witnesses, those called by the SEC dutifully reporting that they had been discouraged by the press release and sold because of it; those called by Texas Gulf testifying that they had found the release encouraging and had either bought or held Texas Gulf stock after read-

ing it. Judge Bonsal held that *both* sets of investors were "reasonable" (183a), but, following what he believed to be the mandate of the Second Circuit, he held that since *some* of those who had sold testified they were misled, the press release was misleading to at least those "reasonable investors" (184a). In addition, the court followed the implicit direction of the appellate court in finding that Texas Gulf had not exercised due diligence in drafting the release, but made no effort to reconcile this conclusion with its previous finding that reasonable business judgment, *i.e.*, due diligence, had been exercised. Thus the District Court held that Texas Gulf had violated Rule 10b-5, but, as there had been no showing of bad faith or of any likelihood of future violations, declined to issue an injunction.

Fogarty and Mollison had voluntarily turned back their stock and Fogarty and Stephens their stock options prior to the first trial, and the District Court held that there was no likelihood of future violations and that injunctive relief was inappropriate. In addition, the court pointed out that they could not have anticipated the extension of the scope of Rule 10b-5, and the rule of materiality in particular, which was later announced by the Second Circuit (196a). Similarly, the application of Rule 10b-5 to the grant of stock options had been novel and no injunctive relief against Stephens and Fogarty was required for that reason as well (211a).

As to Kline, Judge Bonsal felt bound by the mandate to rescind his stock option, but stated "that the remedy directed with respect to Kline merits reconsideration" by the Court of Appeals (213a). For the same reasons expressed as to Stephens and Fogarty, the SEC's application for an injunction was denied.

2. The Court of Appeals

On appeal, the Second Circuit approved the District Court's procedure of hearing a string of investor witnesses in order to determine whether the release was misleading to the reasonable investor, and it also approved the District Court's application of the subjective standard and the "due diligence" test in finding the press release in violation of Rule 10b-5. It further held that the finding of a violation without proof of *scienter* or economic benefit did not abridge the First Amendment, announcing that "the First Amendment deals with the free exchange of ideas and not with commercial 'factual' speech" (224a) and that the press release "is in the same category as corporate registration statements and prospectuses" (225a).

The decision below was in all other respects also affirmed, except that as to petitioner Kline, the court reversed its previous order directing cancellation of the stock option and remanded for further hearing. It affirmed, however, its previous finding that Kline had been in violation of Rule 10b-5, although the court admitted that the question was "an extremely close one factually" and that his violation was of a "borderline nature" (231a).

Reasons for Allowance of the Writ

1. This case marks the culmination of the development of a federal common law of corporations under Rule 10b-5. This development should be reviewed by this Court and limitations placed on the process by which the Rule has supplanted not only state law but specific statutory provisions adopted by Congress in the 1933 and 1934 Acts.

2. Dissemination of information concerning corporate affairs and activities is of great importance to the entire business community and the investing public. In this case the Second Circuit has devised rules governing voluntary disclosures which go far beyond the provisions of the 1934 Act and place impossible burdens of compliance on responsible corporate officials. This will inevitably result in curtailment of information to the public, in direct conflict with one of the basic purposes of the securities laws.

3. The First Amendment has been abridged by the holding that a press release with respect to matters of public interest, prepared for an admittedly laudable purpose and without commercial objective, violates Rule 10b-5.

4. Delineation of appropriate tests for determining whether a fact is "material" under the securities laws is fundamental to the proper administration of those laws. The tests adopted below establish an extremely low threshold of materiality, are hopelessly confusing to the business community and are in conflict with administrative regulations and judicial precedent.

5. The rules governing stock purchases (and receipt of stock options) by corporate employees are of great importance to the business community. Whether Rule 10b-5 is a proper vehicle for such regulation has not been but should be decided by this Court. The decisions below will chill investment by employees in the shares of their own companies and conflict with public policy encouraging such investment.

6. The Court of Appeals not only exceeded the permissible scope of appellate review by overturning and ignoring findings of fact by the trial court, but also made

crucial findings against the weight of the evidence, all contrary to Rule 52(a) F.R.Civ.P.

7. The duties imposed upon petitioners can neither be found in the language of Section 10(b) or Rule 10b-5 nor could they reasonably have been inferred. Petitioners had no fair warning that their conduct would be held illegal, as required by the Fifth Amendment, and as intended by the Administrative Procedure Act.

8. An administrative body empowered by statute to seek injunctions has here been allowed, in conflict with the Ninth Circuit, to obtain monetary penalties, utilizing the slight burden of proof which governs in a purely injunctive proceeding.

ARGUMENT

I

This case raises fundamental and far reaching questions of administration of the securities laws and the proper roles of Congress, the Commission, and the federal courts.

Stated in its broadest terms, the question presented to this Court for review involves the tendency of the lower federal courts, exemplified by the decisions of the Second Circuit herein (66a, 220a), to resolve more and more questions under the rather general language of Rule 10b-5 promulgated by a regulatory agency, rather than under applicable state law or the specific statutory provisions enacted by Congress. It concerns profound changes in substantive law, and the development of what has been termed

a "federal corporation law", under the guise of interpreting an administrative rule in the context of litigation.

Pursuant to statutory authority granted by Congress in §10(b) of the Exchange Act, the Commission has promulgated a series of regulations, most of which are precise and detailed, *e.g.*, Rule 10b-6, 17 C.F.R. §240.10b-6. In Rule 10b-5, however, the Commission adopted the general language of §17 of the Securities Act of 1933, 15 U.S.C. §77q. Instead of following sound principles of administrative law and promulgating comprehensible regulations concerning conduct of the nature attacked in this case, the Commission has proceeded to utilize the general clauses of Rule 10b-5 in a series of judicial contests to obtain revolutionary changes in corporate law with far reaching economic effects and social consequences. That process, culminating in this proceeding, has been compared to nineteenth century Germany's "flight into the general clauses," the tendency "to resolve more and more questions in terms of the handful of clauses in the Civil Code which are based on 'good faith' and similar clauses." 3 Loss, Securities Regulation, pp. 1789-90 (1961). Professor Loss has elsewhere stated, even prior to the Second Circuit's first decision in this case, that he has "become increasingly ashamed * * * at this sort of jurisprudence," continuing:

> "[D]o we have to go on indefinitely basing this whole revolutionary change on a section of the Exchange Act that says it shall be unlawful for any person in the purchase or sale of any security to engage in any act or practice that the S.E.C. prescribes (*sic*) as manipulative or deceptive? How big a house of cards can we continue to build on that? This is back-door jurisprudence with a vengeance." Loss, *History of S.E.C. Legislative Programs And Suggestions for A Code,* 22 Bus. Law. 795, 796 (1967).

The ramifications of this development are broad, and unforeseen consequences appear to follow inexorably from each successive step, as this litigation tellingly demonstrates. Citing cases such as *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180 (1963), the Commission persuaded the courts below that the burden of proof should be reduced and that elements essential in private damage suits need not be shown. Thus, new liabilities and new rules of law are announced, ostensibly limited to the enforcement proceeding seeking mild "prophylactic" relief.

Indeed, the present Chief Judge of the Second Circuit, in concurring with the majority below, acknowledged his concern that the new law announced might be applied in private damage actions, stating that the consequences are "frightening" (123a). Yet as the companion petition in *Reynolds* v. *Texas Gulf Surphur Co.* will reveal, the Tenth Circuit followed the decision below in abandoning the basic element of fraud in private damage suits (themselves implied by the courts), and awarded "damages" against Texas Gulf based upon hypothetical profits that might have been made by former Texas Gulf shareholders. Waiting in the wings are numerous private damage actions against Texas Gulf (71a), including a declared class action involving huge potential damages. *Cannon* v. *Texas Gulf Sulphur Co.,* 47 F.R.D. 60 (S.D.N.Y. 1969).

This case is the cornerstone upon which those private damage actions depend, a matter of serious consequences to Texas Gulf's shareholders. But beyond this, the *Texas Gulf Sulphur* case has been the impetus of a flood of lawsuits under Rule 10b-5. With the advent of Fed. R. Civ. P. 23, revised by this Court in 1966, class actions under Rule 10b-5 have multiplied. (*e.g.,* Note, *Impact of Class*

Actions on Rule 10b-5, 38 U. CHI. L. REV. [Winter, 1971].) Not a single such class action has ever gone to judgment after complete trial. *Morris* v. *Burchard,* 51 F.R.D. 530 (S.D.N.Y. 1971). The consequences of a possible adverse verdict are, in Judge Friendly's words, "frightening", indeed too frightening to risk a trial.

We respectfully submit that this Court should for the first time, in the context of this case, review the basic roles of Congress, the Commission and the courts in bringing about these sweeping changes in the law.

II

The holding below, which runs counter to a basic purpose of the securities laws, counter to the expressed intent of Congress and contrary to precedent, presents to this Court fundamental questions of importance under the securities laws concerning corporate and public information practices.

Section 10(b) and Rule 10b-5 were not designed to regulate voluntary corporate publicity. Section 10(b) was enacted by Congress to enable the Commission to deal with newly conceived manipulative devices by purchasers of securities. See, *e.g.,* Testimony of Thomas G. Corcoran, *Hearings on H. R. 7852 and H. R. 8720 before The House Committee on Interstate and Foreign Commerce,* 73d Cong., 2d Sess. 115 (1934). The Commission was authorized to promulgate regulations to prevent manipulative devices of the kind specifically outlawed in Sections 9 and 10(a) of the Act, which, as the dissenting judges below cogently demonstrated, all involved fraudulent activities integ-

rally related to securities transactions (160a). Congress' concern in drafting antifraud provisions in the securities laws, such as Section 17(a) of the 1933 Act and Section 10(b), was not to regulate public statements, but rather to deal with schemes to deceive and defraud the public by means of manipulative and deceptive devices in the purchase or sale of securities (160a-163a). Not only were no facts presented below which could possibly support findings of such a scheme, but in addition the trial court found that "TGS derived [no] direct benefit from the issuance of the press release"; that none of the defendants "who participated in its preparation used it to their personal advantage" (54a); and that the framers "exercised reasonable business judgment under the circumstances" (58a). These factual findings are antithetical to the concept of manipulation or deception.

Rule 10b-5 was promulgated by the Commission to deal with deliberate fraud by purchasers of securities, as the Commission publicly announced.* Within the meaning of

* "The new rule [10b-5] closes a loophole in the protection against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase" (SEC Sec. Exch. Act Rel. No. 3230 [May 21, 1942]). The actual draftsman of Rule 10b-5 has related that it was drafted in response to the following situation:

> "* * * the president of some company in Boston, who is going around buying up the stock of his company from his own shareholders at $4.00 a share, and he has been telling them that the company is doing very badly, whereas, in fact, the earnings are going to be quadrupled and will be $2.00 a share for this coming year * * *"

The Rule was drafted and presented to the Commission in one afternoon:

> "* * * We passed a piece of paper around to all the commissioners. All the commissioners read the rule and they tossed it on the table, indicating approval. Nobody said anything except Sumner Pike who said, 'Well,' he said, 'we are against fraud, aren't we?' That is how it happened." Freeman, 22 Bus. Law. 922 (1967).

the Rule a press release could be found to be "in connection with" the purchase or sale of securities only if: (1) the corporation or insiders were in fact trading on the basis of such release; or (2) the purpose of the release was to affect the market price of the company's securities to the advantage of the company or its insiders (51a, 54a). Neither element was shown here.

Moreover, dissemination of information about corporate activities was not left unregulated under the 1934 Act. Section 12 of the 1934 Act requires the registration of securities which are widely held, and detailed information, similar to that required by the 1933 Act, must be filed with the Commission for such securities. This information must be kept "reasonably current" by periodic and other reports filed with the Commission and the stock exchanges. Such disclosure is supplemented by Section 14, regarding proxy regulation, and Section 16 regarding insider purchases and sales. Failure to comply with these provisions, or the making of a false statement in filed reports, is punishable civilly under Section 18 of the Act (where good faith is a defense), or criminally under Section 32 of the Act, requiring intentional wrongdoing. The liabilities imposed under these sections must be balanced (as are similar liabilities imposed in the 1933 Act) against the fact that the requirements for disclosure and the standards of conduct are carefully spelled out. The majority in the Second Circuit found legislative support for its holding below by quoting from the legislative history of Section 18 (compare 106a-107a and 162a) but ignored the fundamental difference that press releases are not required under the 1934 Act and no rules and regulations governing their format have ever been promulgated.

At least one respected commentator has warned against such an expansion of Rule 10b-5 to encompass Section 18 (Milton Cohen, *"Truth in Securities" Revisited,* 79 HARV. L. REV. 1340, 1366, 1370 n. 89 (1966)). It cannot be doubted that the imposition of liability under Rule 10b-5 without requiring a showing of an improper purpose runs counter to a basic policy of the securities laws:

> "But to require them [directors] to guarantee the absolute accuracy of every statement that they are called upon to make, would be to gain nothing in the way of an effective remedy and to fall afoul of the President's injunction that the protection of the public should be achieved with the least possible interference to honest business." H. R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

Further, as cogently pointed out by Judge Friendly, the standards announced by the Second Circuit will result not in more publicity, but in a reluctance of corporations to speak out on matters when not legally required to do so.* The standards announced by the Second Circuit for determining whether or not press releases are misleading impose impossible burdens on business and industry in attempting good faith compliance.

The district judge carefully reviewed the expert testimony concerning the relationship of the facts set forth in the press release to the facts of the drilling known to the responsible Texas Gulf officials and the investment sig-

* "* * * [I]f the only choices open to a corporation are either to remain silent and let false rumors do their work, or to make a communication, not legally required, at the risk that a slip of the pen or failure properly to amass or weigh the facts—all judged in the bright gleam of hindsight—will lead to large judgments, payable in the last analysis by innocent investors, for the benefit of speculators and their lawyers, most corporations would opt for the former" (123a).

nificance of those facts, and concluded that on the basis of objective standards and SEC regulations the press release was not "misleading or deceptive on the basis of the facts then known" (58a).

The Second Circuit reversed this objective standard and enunciated a new test: whether the press release was misleading or not should be determined by the subjective reactions of persons in the market and for this purpose the testimony of dozens of investors taken. But an oath-swearing contest is no method by which to ascertain whether a release is misleading or not. If the only requirement upon the SEC was to show that someone who is *in compos mentis* sold stock on the basis of that release, the whole process is a charade.

To the same end is the Court of Appeals' refusal to give effect to the District Court's finding that Texas Gulf had exercised "reasonable business judgment" in choosing when to issue and how to phrase the press release (58a). Instead the Court of Appeals imposed the *ex post facto* requirement that the "basic facts" be stated in all corporate press releases* (117a). Texas Gulf could have pub-

* The entire thrust of the SEC's enforcement procedures under the 1933 and 1934 Act has heretofore been to prohibit the disclosure of such information until conclusions as to probable or proven ore be drawn. See Item 8A(b), Schedule I to Form 1A relating to Regulation A Offerings under the Securities Act of 1933, quoted in the dissenting opinion of Judge Moore (136a-137a). The decision of the Tenth Circuit in *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447, 451 (10th Cir. 1968), recognized the basic wisdom behind this policy, holding that disclosure of details of oil exploration, "would in the first place make the proxy statement impossibly large and in the second place would be disclosing to the average investor, who has no capacity to judge the scientific significance of the information, material which would not be in the least beneficial in making an enlightened judgment about the proxy solicitation."

lished drill logs but the media obviously would not have printed them in full but more likely in a fashion itself misleading. Here, the Texas Gulf management, containing expert geologists and mining engineers, reviewed the available data and concluded that "the work done to date has not been sufficient to reach definite conclusions and any statement as to size and grade of ore would be premature and possibly misleading." This evaluation was concurred in by eminent experts at the trial. But whether the evaluation was correct or not should hardly be the point; what is important is that the statement was a reasonable and responsible exercise of judgment (*i.e.*, due diligence) by the officials of Texas Gulf, and found to be so by the trier of facts (58a).

III

The imposition of liability for negligent misstatement under Rule 10b-5 upon a well-intentioned company responding to false and exaggerated rumors and commenting on its affairs in the form of a press release presents to this Court an important question of freedom of speech.

The decision below presents the important question of the right of a corporation and its managers, when not motivated by thoughts of gain either to itself or to others, to speak freely on matters of public importance concerning corporate activities, without fear of staggering liabilities in subsequent government or private damage actions. Texas Gulf's April 12 press release was just such a comment on matters of front-page significance; it was not shown to have been issued either with knowledge of falsity,

reckless disregard for truth, or to benefit the corporation, its officers or employees. And yet on the basis of alleged negligent misstatement, Texas Gulf was held to have violated Rule 10b-5, which prohibits fraud, not negligence.

The fundamental freedom of speech and expression should not be denied merely because the subject is a corporate activity. The decision below has affected and will continue to affect every comment responsible corporate managements have made or wish to make on developments, both fortunate and adverse, in their corporations' affairs. These holdings, as Judge Friendly noted, will encourage silence, not the free expression by businessmen of their opinions and judgments on corporate developments, to the detriment of the public, for whose benefit the securities laws were enacted. The fear of repercussions from a slip of the tongue or the pen (or from possible misconstruction of a statement or phrase by one looking for a scapegoat for his losses or missed advantages), will act to chill and impede, if not silence, the free flow of expression and comment.

The Court of Appeals has summarily determined that press releases, words spoken by corporations, are not to be afforded the protection of the First Amendment: "the First Amendment deals with the free exchange of ideas and not with commercial 'factual' speech" (234a), analogizing press releases to prospectuses and registration statements (225a). That analogy fails for at least two reasons: first, the press release was found to have had no commercial motivation (54a), and thus is unlike a registration statement which is designed to elicit funds from the general public at large. Second, under the statutes enacted by Congress, and the rules, regulations and forms

adopted by the Commission, there is a "precision of regulation" of the content of registration statements which is compatible with the First Amendment. Here, of course, no guidelines existed.

This Court, in prior decisions, has expressly refused to stifle freedom of comment if one libelously injured can show no more than that the comment was negligently made. *New York Times* v. *Sullivan,* 376 U.S. 254, 287-288 (1964). This Court there refused to hold that an advertisement placed in the *New York Times* was not entitled to protection simply because the *Times* was paid for it. Yet the court below asserts not only that the comment by Texas Gulf on the rumors is not protected because it was "commercial" (although no economic benefit whatsoever accrued to Texas Gulf) but also that Texas Gulf may be held liable for comments allegedly compiled without "due diligence," even though made in good faith for a laudable purpose.*

The protection of the First Amendment must include comment by businessmen on the natural subject of their comment, *i.e.,* their "commercial" businesses; that Amendment "must embrace *all* issues about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period." (Emphasis supplied). *Thornhill* v. *Alabama,* 310 U.S. 88, 102 (1940). This Court recently, in *Rosenbloom* v. *Metromedia,* 91 S.Ct.

* In attempted justification of this holding the court speculated that "it is almost impossible [for the SEC] to prove that a wrongful purpose motivated the issuance of the misleading statement" and that the necessity of so proving would "handicap unreasonably the Commission in its work." (109a-110a, 111a). But surely rights guaranteed by the Constitution cannot be diluted by claims of governmental expediency.

1811, 1820, n. 12 (1971), with respect to the question of constitutional protection of publication made for gain, expressed "no view on the extent of constitutional protection, if any, for purely commercial communications made in the course of business." To the extent that this case presents the question of the First Amendment rights of a business corporation, it involves the question left open in *Rosenbloom*; however, the expression involved here was not "purely commercial" and thus, we submit, the need for review by this Court is even more necessary.

IV

The Second Circuit adopted a test of materiality in conflict with regulations adopted by the Commission, with decisions of the Seventh and Tenth Circuits, and with its own previous decisions.

The concept of materiality is fundamental to federal securities regulation. The 1933 Act and the 1934 Act require accurate disclosure of material facts in all documents filed pursuant to those acts, and those who misrepresent or conceal material facts in violation of those statutes are subject to heavy penalties and liabilities.

Because of the importance of this concept, the SEC has taken great care in drafting rules defining "materiality" under each of the major acts it administers.* All these

* See, *e.g.*, Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) under the Securities Exchange Act of 1934; Rule 1-02(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405 (1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

definitions limit material facts to "those matters as to which *an average prudent investor* ought reasonably to be informed." [Emphasis added] In the present case this traditional test of materiality has been abandoned both by the SEC and the Second Circuit, and replaced with a standard under which a fact can be deemed material merely because it "may" affect the desires of "speculators and chartists" as well as other investors to buy, sell or hold securities, or because the fact "might" have some effect on the market price. Obviously, almost any information could fall in such a category, especially with the aid of hindsight. This unworkable and ill-defined application of Rule 10b-5 has created widespread anxiety throughout the corporate and financial communities. The decision below has "set a regrettably low threshold of materiality." (BROMBERG, SECURITIES LAW: FRAUD—SEC Rule 10b-5, Sec. 7.4(3)(c)).

The "standard" created by the Second Circuit, besides conflicting with the SEC rules, also conflicts with earlier judicial elaborations of the "average prudent investor" test. Thus, the Seventh Circuit in *James Blackstone Memorial Library Ass'n.* v. *Gulf, M. & O. R.R.*, 264 F.2d 445, 450-51 (7th Cir.), *cert. denied*, 361 U.S. 815 (1959), held that only "assured" facts, not mere possibilities, were material. Similarly, in *List* v. *Fashion Park, Inc.*, 340 F. 2d 457, 462 (2d Cir.), *cert. denied sub nom., List* v. *Lerner*, 382 U.S. 811 (1965), the Second Circuit held that material facts were those "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities. * * *" It was this precedent which was initially applied by the District Court (25a-26a), but distorted by the Second Circuit in its first decision. Only by such

distortion could the Second Circuit reach the conclusion that the preliminary drilling results were "material"; the combination of findings by the District Court led inescapably to the conclusions that in "reasonable and objective contemplation" one drill core can not be "material" in a company the size of Texas Gulf; one drill core "does not establish an ore body, much less a mine"; with one drill core you can not "even * * * estimate the probabilities that [it] * * * will lead to the discovery of an ore body"; "no predictions could be made as to how far mineral values * * * extended beyond the 1⅛ inch drill core"; "from an investment point of view, no significance could be attached to the results of a single drill core * * *" (29a-30a). But a speculator may be interested in anything.

Again, it was clear that the drilling results as of the time of petitioners' stock purchases or acceptance of stock options did not indicate the existence of "proven" or "probable" ore under the SEC regulations governing disclosure concerning mining exploration quoted in the dissenting opinion below (136a-137a). In *Sunray DX Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F.2d 447 (10th Cir. 1968), the Tenth Circuit held that equivalent regulations were controlling in determining whether facts concerning oil exploration were "material" and, therefore, to be disclosed in proxy material. The decision below is in conflict with that of the Tenth Circuit, as well as with the Commission's own regulations, and should be reviewed by this Court.

V

It is not unlawful for a corporate employee to purchase his company's stock or to accept stock options in the absence of a showing of fraud and deceit.

In this case, for the first time, the courts have imposed a duty upon officers, directors and employees of a public corporation to refrain from purchasing stock of their corporation at a time when they were said to possess "material" information regarding their corporation, which information had not yet been publicly disclosed.

Prior to this action, it seemed clear that, absent actual fraud or deceit, the sole prohibition under the 1934 Act of "insider" purchases was contained in Section 16(b), prohibiting short-swing trading. Section 16(b) is of course aimed at what Congress considered to be abuse of "inside information". The legislative history of that section shows that Congress considered several alternatives to that objective provision and rejected them all. One of the rejected alternatives was a proposal that the court determine in each case whether the officer, director or principal stockholder had made unfair use of inside information. See H. R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934); 1934 Senate Hearings at 6557. This subjective standard, consciously rejected by Congress in 1934, is what the courts below resurrected in this lawsuit. The legislative history clearly demonstrates that, absent a showing of fraud or deceit, Section 16(b) was designed to be the sole prohibition against insider trading. See *Hearings on H. R. 7852 and H. R. 8720 before The House Committee on Interstate*

and Foreign Commerce, 73d Cong., 2d Sess. 135 (1934) and *Hearings on H. R. 4344, H. R. 5065 and H. R. 5832 before The House Committee on Interstate and Foreign Commerce,* 77th Cong., 1st Sess. 1255 (1941). Yet it was the legislative history of §16(b) that the Second Circuit utilized to establish the rule specifically rejected by Congress.

Judge Learned Hand observed in 1949 that Congress intended to regulate insider trading "by forbidding 'quick turns' in shares by a director, yet circumscribing his freedom no further." (dissenting opinion) *In re Calton Crescent, Inc.,* 173 F. 2d 944, 952 (2d Cir. 1949), *aff'd sub nom. Manufacturers Trust Co.* v. *Becker,* 338 U.S. 304 (1949). See also *Blau* v. *Max Factor & Co.,* 342 F.2d 304 (9th Cir.), *cert. denied,* 382 U.S. 892 (1965). The Securities and Exchange Commission apparently concurred with Judge Hand's view, as recently as 1957. Petition of SEC as *amicus curiae* for rehearing in *Greene* v. *Dietz,* 247 F.2d 689 (2d Cir. 1957); see CCH Fed. Sec. L. Rep. ¶90,821 at 92,576 (1957).

In the absence of fraud and lack of any manipulative effect, there can be no justification for holding that the broad prohibitions of Section 10(b) and Rule 10b-5 were designed to cover the purchase of stock on a stock exchange by corporate employees. The mere placing by an insider of an order to buy stock on a securities exchange would not cause a seller to rely thereon; there can be neither deception, reliance or causation in such a situation. Moreover, the Second Circuit read out of the statute the requirement of *scienter,* holding that "unreasonable or negligent conduct" was sufficient to establish a violation of Rule 10b-5

(100a). When not some, but *all* the elements of fraud are read out of Rule 10b-5, it can no longer be termed a fraud rule. The interpretation of Rule 10b-5 adopted below cannot be upheld, for a rule of absolute liability is *ultra vires* the Commission's power to proscribe "manipulative or deceptive devices" under Section 10(b). See 3 Loss, SECURITIES REGULATION, p. 1766 (1961).

Similarly, with respect to the acceptance of stock options by Stephens, Fogarty and Kline, the Court of Appeals enunciated new rules of intra-corporate responsibility which have no relation to concepts of fraud and deceit. The grant of options was not induced by petitioners. Indeed, the evidence shows that Kline with his limited knowledge was not even aware that the outside directors had never heard of the first drill hole at Timmins. In imposing liability on these petitioners based on a record which contained no evidence of misrepresentation or breach of duty of disclosure, no *scienter,* and no knowledge of material facts, as previously defined by the Commission and the Courts, the court below totally departed from the language of Rule 10b-5 and created an impossible and unascertainable standard of conduct.

VI

The Court of Appeals completely disregarded Rule 52(a) in (1) reaching geological, geophysical and investment conclusions which were contrary to findings of the trial court and without support in the record and (2) in implicitly overruling Judge Bonsal's finding that Texas Gulf officers had "exercised reasonable business judgment" (*i.e.*, acted with due diligence) in issuing the April 12 release.

The Court of Appeals reached its conclusion that the results of the first hole constituted "material information" by ignoring or overturning findings of fact of the trial judge, based on his appraisal of the testimony of eleven expert witnesses, and his study of numerous exhibits and charts containing geological and geophysical data. The District Court credited expert testimony to the effect that "one drill core does not establish an ore body, much less a mine" and, indeed, that "there is no way even to estimate the probabilities that one drill core will lead to the discovery of an ore body"; that "no predictions could be made as to how far mineral values encountered by [the first drill core] extended beyond the 1⅛ inch drill core", and that "from an investment point of view, no significance could be attached to the results of a single drill hole" (30a). The District Court also found that disclosure of the preliminary drilling results would not have had a substantial impact on the market price of Texas Gulf's 10,000,000 outstanding shares (30a).

The majority of the Court of Appeals did not give the findings of the District Court the consideration and weight

required by law. As pointed out by Chief Judge Lumbard and Judge Moore, dissenting, the majority, in disregard of Fed. R. Civ. P. 52(a), chose "to reject the trial court's finding as to the results of the first drill core, K-55-1, and to substitute their own expertise in the mining engineering field * * *" (135a).*

Thus, the majority stated that from the first hole there was a "possibility which surely was more than marginal of the existence of a mine of * * * vast magnitude * * *" (89a), an interpretation of the geological and geophysical data directly at odds with that of the District Judge and the "virtually uncontradicted testimony" of the experts (135a). Indeed, the court below never referred to the distinguished experts called by defendants and credited by the District Judge, but heavily relied on the deposition of one Michael Roche, a Canadian penny stock speculator, to support its geological and investment conclusions (90a). The procedures followed below conflict with basic principles of appellate jurisdiction repeatedly stated by this Court (see, *e.g., Graver Tank & Mfg. Co. Inc.* v. *Linde Air Prods. Co.*, 339 U.S. 605-10 (1950)) and should be corrected.

Furthermore, the Court of Appeals ignored or misunderstood Judge Bonsal's finding that under all the circumstances Texas Gulf's officials had acted with due diligence in drafting and issuing the release (57a-58a). Apparently because Judge Bonsal used the phrase "reasonable busi-

* With respect to the press release, the Court of Appeals ignored the findings of the District Court based on the testimony of defendants' experts that Kidd 55 was still a prospect, that "no estimates as to proven or probable ore could be made", and "that the April 12 press release accurately set forth the situation as it was known at the time" (56a). It indicated its belief that, despite these findings, the press release was probably misleading (114a).

ness judgment under the circumstances" rather than "due diligence", the Court of Appeals concluded that he had not passed on the point and the appellate court included the question of due diligence in its remand. However, the majority opinion indicated so strongly the view of the majority of the circuit judges that due diligence had not been exercised that Judge Bonsal felt constrained to bow to what he regarded as the command of the appellate court rather than to reassert his own conclusion (186a, 188a).

VII

The decisions of the courts below violate petitioners' constitutional rights under the Fifth Amendment and well-settled principles of administrative procedure.

The Fifth Amendment requires that:

> "* * * a fair warning should be given to the world in language that the common world will understand, of what the law intends to do if a certain line is passed. To make the warning fair, so far as possible, the line should be clear." *McBoyle* v. *United States*, 283 U.S. 25, 27 (1931) (Holmes, J.).

A finding of violation of a statute "ought not to rest upon an interpretation reached by the use of policy judgments rather than by the inexorable command of relevant language." *M. Kraus & Bros., Inc.* v. *United States*, 327 U.S. 614, 626 (1946). In *Kraus* it was held that an administrative body must frame its rules so "that the ordinary person can know in advance how to avoid an unlawful course of action." *Id.* at 622. See also *Boyce Motor Lines, Inc.* v. *United States*, 342 U.S. 337 (1952). Rule 10b-5 certainly

gave no warning to petitioners that their conduct in issuing a press release or in purchasing their company's stock, or accepting stock options could be held in violation of a statute and rule prohibiting manipulative or deceptive devices. The publicity generated by this case proves that no fair warning was given.

If it is assumed, *arguendo,* that the Commission had authority to propose regulations covering the law made in this case, public comment and hearing as required by the Administrative Procedure Act would have afforded deliberative weighing of the social and economic consequences of the regulations. But rather than promulgate a rule which would operate prospectively, respondent has instead persuaded the Court of Appeals, in this case of first impression, to hold petitioners' various conduct to be employments "of a manipulative or deceptive device or contrivance."

The Court of Appeals' opinions are the unfortunate result of the exigencies of litigation rather than the product of the regulatory process entrusted to the SEC by Congress. It is important that this Court consider the statutory and constitutional limitations upon respondent's powers and the unfair procedures whereby the statute and rule have been extended, without prior notice and without regard to proper legislative and administrative procedures, far beyond their language and purpose. *Cf. Blau* v. *Lehman,* 368 U.S. 403 (1962).

VIII

Whether the SEC, in an enforcement proceeding under Section 21(e) of the 1934 Act, may seek a remedy which requires a stock option to be rescinded, is an issue as yet undecided by this Court and as to which a conflict exists between the Second and Ninth Circuits.

As to petitioner Kline the court below remanded to the District Court, which has held Kline liable for the difference between the option price and the price of Texas Gulf stock on April 17, 1964. This holding, together with the holding by the court below that in an enforcement proceeding under Section 21(e) of the 1934 Act the SEC may seek not only injunctive relief but also restitution and rescission (228a) presents a legal issue which may be considered along with the similar issue raised by other petitioners.*

The court below reached its conclusion that such remedies may be sought even in the light of express statutory language to the contrary; Section 21(e) states that the SEC may "bring an action * * * to enjoin such acts or practices [which constitute or will constitute a violation of the provisions of this title, or of any rule or regulation thereunder]". The court held that Section 27 of the 1934 Act, which is a general grant of jurisdiction to the District Courts, is authority for the proposition that the SEC may seek in an enforcement proceeding remedies equivalent to damages or penalties. With this conclusion the Court of Appeals for the Ninth Circuit, construing similar provi-

* See the companion petitions of Crawford, Huntington, Clayton, Holyk and Darke.

sions, has disagreed. *United States* v. *Parkinson,* 240 F. 2d 918 (1956). The wisdom of the rationale of that decision is plain in the context of this proceeding, and the conflict between the Circuits becomes an important question for this Court to decide. The SEC, by bringing this action as an enforcement proceeding under Section 21(e), has obtained decisions by which it may extract not only from petitioners but also from future defendants substantial sums, utilizing a lesser quantum of proof than would be necessary for it to establish a violation under Section 32 with its criminal sanctions.

On this issue this Court has expressly reserved opinion in a previous decision. *SEC* v. *National Securities, Inc.,* 393 U.S. 453, 462, n. 5 (1969).

IX

The Court below erroneously denied to petitioners an opportunity for oral argument of the issues before a quorum of the Court sitting *en banc*.

The court below rendered its *en banc* decision in 1968 without affording petitioners an opportunity for oral argument before a quorum of the active judges of the circuit. The need for review of this practice is developed in the companion petition of David Crawford and need not be repeated here.

Conclusion

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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ADDENDUM

Indicative of the importance of the issues presented by this petition and companion petitions is the number of texts devoted either entirely or in part to it. Among the most noteworthy of these are:

A. Bromberg, Securities Law: Fraud—SEC Rule 10b-5 (1969): ("The filing of the Texas Gulf Sulphur suit gave us all a jolt"); ("celebrated case").

A. Fleischer, Jr. & J. Flom, Texas Gulf Sulphur—Insider Disclosure Problems (PLI 1968); ("One of the most troublesome decisions in recent years in the corporate field"—E. Donald Shapiro, PLI Director).

J. Flom, B. Garfinkel & J. Freund, Disclosure Requirements of Public Companies and Insiders (PLI 1967).

H. Manne, Insider Trading and the Stock Market (1966).

W. Painter, Federal Regulation of Insider Trading (1968): ("The rumblings first heard in the *Cady, Roberts & Co.* case * * * have attained earthquake proportions with the * * * announcement by the Second Circuit Court of Appeals of its *en banc* decision in *SEC* v. *Texas Gulf Sulphur Co.*").

Over one hundred law review articles, comments and notes have been published on this case, its impact on the financial community, and the novel questions it raises. The following are illustrative.

Bradford, "*Rule 10b-5: The Search for a Limiting Doctrine.*" 19 Buffalo Law Review 205 (1970).

Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications,* 22 Sw. L. J. 731 (1968); ("landmark decision"); ("*TGS* takes antifraud securities law significantly farther along the paths traced in recent years").

Bromberg, *Disclosure Programs for Publicly Held Companies—A Practical Guide,* 1970 Duke L. J. 1139; ("historic decision").

Delancey, *Rule 10b-5—A Recent Profile,* 25 Bus. Law. 1355 (1970); ("*Texas Gulf* * * * operates to compound rather than to contain the problem.").

Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding,* 51 Va. L. Rev. 1271 (1965); ("generated an unprecedented amount of comment").

Harfield, *Texas Gulf Sulphur and Bank Internal Procedures Between the Trust and Commercial Departments,* 86 Banking L. J. 869 (1969); (a landmark but not a guidepost).

Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5,* 62 Nw. U. L. Rev. 809 (1968).

Kennedy & Wander, *Texas Gulf Sulphur, A Most Unusual Case,* 20 Bus. Law. 1057 (1965); ("the beginning of what could be a revolutionary change in [SEC] practice").

Knauss, *Disclosure Requirements—Changing Concepts of Liability,* 24 Bus. Law. 43 (1968).

Leavell, *The Texas Gulf Sulphur Opinion in the Appellate Court: An Open Door to Federal Control of Corporations,* 3 U. Ga. L. Rev. 141 (1968).

Manne, *Insider Trading and the Administrative Process,* 35 GEO. W. L. REV. 473 (1967). ("In *SEC* v. *Texas Gulf Sulphur Co.,* the development [of a federal law on insider trading] is certainly nearing some sort of pinnacle"); ("famous case"); ("A great many legal questions at issue").

Marsh, *What Lies Ahead Under Rule 10b-5?,* 24 BUS. LAW. 69, 73 (November 1968). ("What lies ahead under Rule 10b-5 * * * Chaos!)

Osborn, *Texas Gulf Sulphur: A Vigorous Assault on Insider Trading and Misleading Press Releases,* 11 ARIZ. L. REV. 290 (1969); ("a decision significant both for its far-reaching impact on the state of the law as it then existed and for the serious questions which it raises").

Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5,* 65 COLUM. L. REV. 1361 (1965); (raising novel questions); (spectacular nation-wide publicity).

Posner, *Developments in Federal Securities Regulation,* 22 BUS. LAW. 645 (1967).

Posner, *Developments in Federal Securities Regulation,* 21 BUS. LAW. 703 (1966).

Ruder, *Texas Gulf Sulphur—The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases,* 63 NW. U. L. REV. 423 (1968). (A case raising "serious questions regarding the extent to which liability should be imposed for violation of * * * Rule 10b-5").

Whitney, *Section 10b-5: From Cady, Roberts to Texas Gulf: Matters of Disclosure,* 21 BUS. LAW. 193, 194 (1965). ("source of concern, not to say frustration, to corporate management and counsel").

Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur,* 28 MD. L. REV. 189 (1968).

Wu, *An Economist Looks at Section 16 of the Securities Exchange Act of 1934*, 68 COLUM. L. REV. 260 (1968); ("*SEC* v. *Texas Gulf Sulphur Company* has stimulated great interest in and out of the legal profession").

Note, *SEC* v. *Texas Gulf Sulphur Co.: The Inside and Outside of Rule 10b-5*, 46 BOSTON U. L. REV. 205 (1966); ("an excellent opportunity for the federal judiciary to provide clear guidelines which have to date been lacking under Rule 10b-5").

Note, *Corporate Recovery for Insider Violations*, 36 BROOKLYN L. REV. 78 (1969); ("landmark opinion").

Note, *Insider Disclosure—A Conflict Between Section 5(c) and Rule 10b-5*, 37 BROOKLYN L. REV. 123 (1970); ("leading case").

Symposium—*Insider Trading in Stocks*, 21 BUS. LAW. 1009 (1966).

Note, *Scienter and Rule 10b-5*, 69 COLUM. L. REV. 1057 (1969); ("Few decisions have had as much impact on the securities market").

Note, *A Suggested Locus of Recovery in National Exchange Violations of Rule 10b-5*, 54 CORNELL L. REV. 306 (1969): (may result in "judicial and administrative chaos").

Note, *Scienter in Private Damage Actions Under Rule 10b-5*, 57 GEO. L. J. 1108 (1969); ("landmark case").

Note, 82 HARV. L. REV. 938 (1969).

Note, *Rule 10b-5: The Effect of the Insider Trading Decisions on the Security Analyst*, 54 MINN. L. REV. 147 (1969); ("major case of the decade").

Note, *Impact of Class Actions on Rule 10b-5*, 38 U. CH. L. REV. (Winter, 1971).

Note, *The Corporation's Obligations of Disclosure Under the Federal Securities Laws When It Is Not Trading in Its Stock,* 15 N.Y.L.F. 385 (1969); ("development of great importance").

Note, *Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure Under SEC Rule 10b-5,* 43 ST. JOHN'S L. REV. 425, 655 (1969) (two parts); ("landmark opinion") ("historical decision"); ("so far-reaching in its possible applications that the final disposition of the relevant issues could directly affect the operating procedures of virtually all phases of our nation's vast securities industry"); ("monumental impact").

Comment, 16 UCLA L. REV. 404 (1969).

Note, *Texas Gulf Sulphur: Its Holdings and Implications,* 22 VAND. L. REV. 359 (1969); ("seldom has any development been met with such a reaction by the financial press").

Editorial, *The Wall Street Journal* (August 31, 1968); ("REGULATION CARRIED TO ABSURDITY").

Editorial, *The Wall Street Journal* (August 21, 1968); ("The potential impact of the Federal Circuit Court's ruling, however, is tremendous. * * * Common sense obviously is not served by a court decision that seems written to foster indecision and confusion.")

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In the Supreme Court of the United States

OCTOBER TERM, 1971

TEXAS GULF SULPHUR COMPANY, ET AL., PETITIONERS
v.
SECURITIES AND EXCHANGE COMMISSION

EARL L. HUNTINGTON, PETITIONER
v.
SECURITIES AND EXCHANGE COMMISSION

DAVID M. CRAWFORD, PETITIONER
v.
SECURITIES AND EXCHANGE COMMISSION

WALTER HOLYK, ET AL., PETITIONERS
v.
SECURITIES AND EXCHANGE COMMISSION

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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INDEX

	Page
Opinions below	1
Jurisdiction	2
Questions presented	2
Statute and rule involved	4
Statement	4
1. The Commission's complaint	6
2. The evidence relevant to petitioners	7
3. The judicial decisions:	
A. The initial decisions of the district court and the court of appeals: The violations	14
Insiders purchasing Texas Gulf stock and "tipping" others to purchase	15
Insiders' acceptance of stock options	17
Texas Gulf's April 12, 1964, press release	18
B. The subsequent decisions of the district court and the court of appeals: The appropriate remedy:	
The individual defendants	21
Texas Gulf's April 12, 1964, press release	23
Argument	25
Conclusion	49

CITATIONS

Cases:

	Page
Aberlin v. *Zisman*, 244 F. 2d 620, certiorari denied, 355 U.S. 857	5
Banzhaf v. *Federal Communications Commission*, 405 F. 2d 1082, certiorari denied *sub nom. Tobacco Institute* v. *Federal Communications Commission*, 396 U.S. 842	45
Blau v. *Lehman*, 368 U.S. 403	39
Blyth & Co., CCH Fed. Sec. L. Rep. ¶77,647 (S.E.C.)	38
Bowles v. *Skaggs*, 151 F. 2d 817	43
Breard v. *City of Alexandria*, 341 U.S. 626	45
Broffe v. *Horton*, 172 F. 2d 489	41
Cady, Roberts & Co., 40 S.E.C. 907	37
Cannon v. *Texas Gulf Sulphur Co.*, 323 F. Supp. 990	27
Chasins v. *Smith, Barney & Co.*, 438 F. 2d 1167	33
Cochran v. *Channing Corp.*, 211 F. Supp. 239	36
Columbia Broadcasting System v. *United States*, 316 U.S. 407	47
Curtis Publishing Co. v. *Butts*, 388 U.S. 130	45
Davis v. *National Mortgage Corp.*, 320 F. 2d 90	5
Deckert v. *Independence Corp.*, 311 U.S. 282	42
Diamond v. *Oreamuno*, 24 N.Y. 2d 494, 301 N.Y.S. 2d 78	36, 44
Donaldson v. *Read Magazine, Inc.*, 333 U.S. 178	44, 45
Electrical Fittings Corp. v. *Thomas & Betts Co.*, 307 U.S. 241	27
Ellis v. *United States*, 206 U.S. 246	28

Cases—Continued

	Page
Federal Communications Commission v. *WJR*, 337 U.S. 265	47
Ferraioli v. *Cantor*, 281 F. Supp. 354	38
Fink v. *Coates*, 323 F. Supp. 988	27
Freed v. *Szabo Food Service, Inc.*, CCH Fed. Sec. L. Rep. ¶91,317 (N.D. Ill.)	31
G.W.K., Inc. v. *Philco Corp.*, 276 F. 2d 928	5
Halsted v. *Securities and Exchange Commission*, 182 F. 2d 660	46
Heit v. *Weitzen*, 402 F. 2d 909, certiorari denied, 395 U.S. 903	30, 31
Herpich v. *Wallace*, 430 F. 2d 792	30, 31
Herbert L. Honohan, 13 S.E.C. 754, modified in other respects, 16 S.E.C. 297	38
Hooper v. *Mountain States Securities Corp.*, 282 F. 2d 195, certiorari denied, 365 U.S. 814	31
Hughes & Treat, 22 S.E.C. 623	37
Investors Management Co., Inc., CCH Fed. Sec. L. Rep. ¶ 78,163 (S.E.C.)	38
J. I. Case Co. v. *Borak*, 377 U.S. 426	42
James Blackstone Memorial Library Ass'n v. *Gulf, M. & O.R.R. Co.*, 264 F. 2d 445, certiorari denied, 361 U.S. 815	34
Jones v. *Alfred H. Mayer Co.*, 392 U.S. 409	42
Jordan v. *DeGeorge*, 341 U.S. 223	46
Kahan v. *Rosenstiel*, 424 F. 2d 161, certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950	30, 31
Kardon v. *National Gypsum Co.*, 73 F. Supp. 798, modified in other respects, 83 F. Supp. 613	36
Kuehnert v. *Texstar Corp.*, 412 F. 2d 700	38

Cases—Continued Page

Kohler v. *Kohler Co.*, 319 F. 2d 634 ..... 33, 36
Lankenau v. *Coggeshall & Hicks*, 350 F. 2d 61 .. 42, 43
Lehigh Valley Trust Co. v. *Central National Bank*, 409 F. 2d 989 33
List v. *Fashion Parks, Inc.*, 340 F. 2d 457, certiorari denied *sub nom. List* v. *Lerner*, 382 U.S. 811 ..... 33, 36, 41
Los Angeles Trust Deed & Mortgage Exchange v. *Securities and Exchange Commission*, 285 F. 2d 162, certiorari denied, 366 U.S. 919 .. 43
Mansfield Hardwood Lumber Co. v. *Johnson*, 268 F. 2d 317, certiorari denied, 361 U.S. 885 36
Martin v. *City of Struthers*, 319 U.S. 141 45
Matheson v. *Armbrust*, 284 F. 2d 670 30
Meisel v. *North Jersey Trust Co.*, 218 F. Supp. 274 31
Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH Fed. Sec. L. Rep. ¶77,629 (S.E.C.) .. 38
Mills v. *Electric Auto-Lite Co.*, 396 U.S. 375 .. 33, 42
Mitchell v. *DeMario Jewelry*, 361 U.S. 288 .... 42, 43
Mitchell v. *Texas Gulf Sulphur Co.*, 446 F. 2d 90, petition for certiorari filed (No. 71–421) .. 34
Mosser v. Aarrow, 341 U.S. 267 ..... 38, 44
Murdock v. *Pennsylvania*, 319 U.S. 105 45
Myzel v. *Fields*, 386 F. 2d 718, certiorari denied, 390 U.S. 951 ..... 33, 36, 41
National Labor Relations Board v. *Wyman-Gordon Co.*, 394 U.S. 759 47
New York State Broadcasters Assoc. v. *United States*, 414 F. 2d 990, certiorari denied, 396 U.S. 1061 45
New York Telephone Company v. *Maltbie*, 291, U.S. 645 27

Cases—Continued

	Page
New York Times v. *Sullivan*, 375 U.S. 254	45
Northwest Paper Corp. v. *Thompson*, 421 F. 2d 137	33
Partin v. *Hassan Motors, Inc.*, 363 F. 2d 104	5
Partmar Corp. v. *Paramount Pictures Theatre Corp.*, 347 U.S. 89	27
Porter v. *Warner Holding Co.*, 328 U.S. 395	42
R. D. Bayly & Co., 19S.E.C. 773	37
Rachal v. *Hill*, 435 F. 2d 59, certiorari denied, 403 U.S. 904	27
Reed v. *Riddle Airlines*, 266 F. 2d 314	36
Rekant v. *Aesser*, 425 F. 2d 872	30
Rogen v. *Ilkon Corp.*, 361 F. 2d 260	33
Rosenbloom v. *Metromedia, Inc.*, 403 U.S. 29	45
Ross v. *Licht*, 263 F. Supp. 395	38
Schine Chain Theatres, Inc. v. *United States* 334 U.S. 110	43
Securities and Exchange Commission v. *Aldred Investment Trust* (S.D.N.Y.) (Litigation Release No. 2081, Aug. 11, 1961)	37
Securities and Exchange Commission v. *Boyd Transfer & Storage Co.* (D. Minn.) (Litigation Release No. 295, Aug. 20, 1945; Litigation Release No. 308, Dec. 7, 1945)	37
Securities and Exchange Commission v. *C. M. Joiner Leasing Corp*, 320 U.S. 344	43
Securities and Exchange Commission v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180	28, 46
Securities and Exchange Commission v. *Chenery*, 318 U.S. 80	39
Securities and Exchange Commission v. *Chenery Corp.*, 332 U.S. 194	47

Cases—Continued Page

Securities and Exchange Commission v. *First Investment Co.* (D.N.H.) (Litigation Release No. 281, June 20, 1945)..... 37

Securities and Exchange Commission v. *Gentile* (S.D.N.Y.) (Litigation Release No. 323, Feb. 12, 1946)..... 37

Securities and Exchange Commission v. *Golconda Mining Co.*, CCH Fed. Sec. L. Rep. ¶93,058 (S.D.N.Y.)..... 43

Securities and Exchange Commission v. *Great American Industries, Inc.*, 407 F. 2d 453 (*en banc*), certiorari denied, 395 U.S. 920..... 31, 33

Securities and Exchange Commission v. *May*, 229, F. 2d 123..... 46

Securities and Exchange Commission v. *National Securities, Inc.*, 393 U.S. 453..... 36, 39

Securities and Exchange Commission v. *R. A. Holman & Co.*, 366 F. 2d 456, rehearing denied *per curiam*, 377 F. 2d 665, certiorari denied, 389 U.S. 991..... 33

Securities and Exchange Commission v. *Redfield* (D. Mass.) (Litigation Release No. 899, Feb. 24, 1955)..... 37

Securities and Exchange Commission v. *Texas Gulf Sulphur Co.*, CCH Fed. Sec. L. Rep. ¶93,211 (S.D.N.Y., 1971)..... 23, 27

Securities and Exchange Commission v. *Wall Street Transcript Corp.*, 422 F. 2d 1371, certiorari denied, 398 U.S. 958..... 46

Securities and Exchange Commission v. *Wong*, 252 F. Supp. 608..... 43

Shenker v. *Baltimore & Ohio R.R. Co.*, 374 U.S. 1..... 48

Cases—Continued

	Page
Smolowe v. *Delendo Corp.*, 136 F. 2d 231, certiorari denied, 320 U.S. 751	39
Speed v. *Transamerica Corp.*, 99 F. Supp. 808, final judgment awarded, 135 F. Supp. 176, affirmed as modified, 235 F. 2d 369	36, 37
Stevens v. *Turner*, 222 F. 2d 352	5
Stockwell v. *Reynolds & Co.*, 252 F. Supp. 215	31
Strong v. *Repide*, 213 U.S. 419	36
Studer v. *Moore*, 153 F. 2d 902	5
Sullivan v. *Committee on Admissions and Grievances*, 395 F. 25 954	27
Sullivan v. *Little Hunting Park*, 396 U.S. 229	42
Sunray DX Oil Co. v. *Helmerich & Payne, Inc.*, 398 F. 2d 447	34
Superintendent of Insurance of New York v. *Bankers Life and Casualty*, 430 F. 2d 355, reversed this Term No. 70–60, decided November 1, 1971	29, 31
Tcherepnin v. *Knight*, 389 U.S. 332	28
Textile Workers Union v. *Lincoln Mills*, 353 U.S. 448	42
Thornhill v. *Alabama*, 310 U.S. 88	45
United States v. *Amick*, 439 F 2d 351, certiorari denied, No. 70–134, Oct. 12, 1971	46
United States v. *General Motors Corp.*, 384 U.S. 127	36
United States v. *Moore*, 340 U.S. 616	42
United States v. *Parke, Davis & Co.*, 362 U.S. 29	36
Valentine v. *Chrestensen*, 316 U.S. 52	45
Ward La France Truck Corp., 13 S.E.C. 373	37
Western Pacific R.R. Corp. v. *Western Pacific R.R. Co.*, 345 U.S. 247	48
Wohl v. *Blair & Co.*, 50 F.R.D. 89	38

Constitution, Statutes, rules and regulations:

	Page
United States Constitution:	
First Amendment	25, 44
Fifth Amendment	46
18 U.S.C. 1001	49
18 U.S.C. 1621	49
28 U.S.C. 46(c)	47, 48
Investment Advisers Act of 1940:	
Section 206, 15 U.S.C. 80b–6	28
Securities Exchange Act of 1933:	
Section 11(b)(3), 15 U.S.C. 77k(b)(3)	35
Securities Exchange Act of 1934:	
Section 2, 15 U.S.C. 78b	31, 41
Section 10(b), 15 U.S.C. 78j(b)	*passim*
Section 13, 15 U.S.C. 78m	31
Section 15(d), 15 U.S.C. 78*o*(d)	31
Section 16(b), 15 U.S.C. 78p(b)	39, 40
Section 20(b), 15 U.S.C. 78t(b)	44
Section 21(e), 15 U.S.C. 78u(e)	23, 42
Section 27, 15 U.S.C. 78aa	23, 42
Federal Rules of Appellate Procedure:	
Rule 2	48
Rule 34	48
Federal Rules of Civil Procedure:	
Rule 52(a)	35
Rule 54(b)	5
Rules under the Securities Exchange Act of 1934:	
Rule 10b–5, 17 CFR 240.10b–5	*passim*
Rules 13a–1 to 13b–1, 17 CFR 240.13a–1–.13b–1	31
Rules 15d–1 to 15d–21, 17 CFR 240.15d–1–.15d–21	31

Legislative history and other Congressional material: Page
78 Cong. Rec. (1934) 29
H.R. 7852, 73d Cong., 2d Sess. (1934) 39
H.R. 9323, 73d Cong., 2d Sess. (1934) 40
H.R. Rep. No. 1383, 73d Cong., 2d Sess. (1934) 30, 31, 35
H.R. Rep. No. 1838, 73d Cong., 2d Sess. (1934) 40
Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720, 73d Cong., 2d Sess. (1934) 30, 39
Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Cong.) and S. Res. 56 and 97 (73d Cong.) and 97 (73d Cong.), 73d Cong., 1st and 2d Sess. (1934) 39
S. 2693, 73d Cong., 2d Sess. (1934) 39
S. 3420, 73d Cong., 2d Sess. (1934) 40
S. Rep. No. 792, 73d Cong., 2d Sess. (1934) 30
S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) 29, 40
Miscellaneous:
Advisory Committee Notes on Rule 54(b) (1961 Amendments) 5
American Stock Exchange Company Guide (1970) 26
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449-415—71——2

Miscellaneous—Continued

Page

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Miscellaneous—Continued Page

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Form S–2, General Instruction D(b), 1 CCH Fed. Sec. L. Rep. ¶7142..... 35
Form S–3, General Instruction E(b), 1 CCH Fed. Sec. L. Rep. ¶7152..... 35

In the Supreme Court of the United States

OCTOBER TERM, 1971

Nos. 71-327, -328, -346, -347

TEXAS GULF SULPHUR COMPANY, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

EARL L. HUNTINGTON, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

DAVID M. CRAWFORD, PETITIONER

v.

SECURITIES AND EXCHANGE COMMISSION

WALTER HOLYK, ET AL., PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITIONS FOR WRITS OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 220a-233a) is reported at 446 F. 2d 1301. The opinion

of the district court (Pet. App. 175a–214a)[1] is reported at 312 F. 2d 77. The prior opinions of the court of appeals (Pet. App. 66a–171a) and the district court (Pet. App. 1a–63a) are reported respectively at 401 F. 2d 833 and 258 F. Supp. 262.

JURISDICTION

The judgment of the court of appeals was entered on June 10, 1971 (Pet. App. 220a).[2] The petitions for writs of certiorari were filed on September 3, 1971, and September 8, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1). Because petitioners' notice of appeal to the court of appeals may have been a nullity (see n. 9 *infra*), there may be a question as to the jurisdiction of this Court.

QUESTIONS PRESENTED

1. Whether Rule 10b–5 of the Securities and Exchange Commission, which proscribes activities operating as a fraud or deceit upon any person in connection with the purchase or sale of securities, validly outlaws

(a) the issuance without due care of a materially misleading corporate press release reasonably calculated to influence the investing public;

(b) trading by insiders in securities of their corporation on the basis of undisclosed material facts and

[1] "Pet. App." refers to petitioners' appendix in No. 71–327.

[2] The prior judgment of the court of appeals was entered on August 13, 1968. Petitioners filed a petition for rehearing on September 20, 1968, which was denied on October 7, 1968. Separate petitions for certiorari were filed by Harold B. Kline, who once again seeks review in No. 71–327, and by Francis G. Coates. Both petitions were denied. 394 U.S. 976.

the giving of tips for others to trade on the basis of such facts; and

(c) the acceptance by top corporate officials of stock options without disclosing to the corporate directors granting such options material nonpublic information affecting the market value of the corporation's stock.

2. Whether a press release issued by petitioner Texas Gulf Sulphur Company to deny newspaper stories respecting a rumored ore discovery by Texas Gulf was materially misleading and issued without due care.

3. Whether information respecting Texas Gulf's drilling into what proved to be a remarkably rich deposit of copper, zinc, and silver ore was material information that should have been disclosed when insiders of the company purchased its stock, gave tips or accepted stock options.

4. Whether the court of appeals properly held that the district court did not abuse its discretion in enjoining the commission of future similar violations by certain insiders of Texas Gulf who had purchased its stock "knowing beyond peradventure of a doubt that [Texas Gulf] had made a very important mineral discovery" that had not been disclosed.

5. Whether Section 27 of the Securities Exchange Act, granting the district court jurisdiction over violations of the Act and over all suits in equity to enforce any liability or duty created by the Act, authorized the district court, in an injunction action brought by the Commission, to direct that the profits resulting from violations of the Act be given up, both

by violators who are enjoined and by those who are not enjoined.

6. Whether a court of appeals can decide a case *en banc* when only a three-judge panel has heard oral argument and, if not, whether the precedure can be attacked by parties who failed to object when the court announced that it intended to follow such procedure.

STATUTE AND RULE INVOLVED

Sections 10(b), 21(e) and 27 of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), 78u(e) and 78aa, and Rule 10b–5 of the Commission, 17 CFR 240.10b–5, are set out at Pet. App. 235a–239a.

STATEMENT

This action arises out of "a major strike of zinc, copper and silver * * *" (Pet. App. 40a) by Texas Gulf Sulphur Company ("Texas Gulf") on land located near Timmins, Ontario, Canada. The exploratory drilling that preceded a news release distributed at a press conference announcing this discovery on April 16, 1964, was carried out by Texas Gulf in the preceding five-month period (Pet. App. 1a). The courts below found that, prior to sufficient dissemination of this announcement to the public, ten officers, directors and employees of Texas Gulf, who possessed various degrees of information about the results of the drilling at various stages in the exploration, all engaged in securities transactions in violation of Section

10(b) of the Securities Exchange Act and the Commission's Rule 10b–5.

The court of appeals affirmed the judgment entered April 16, 1970, against six of the nine individual petitioners: Harold B. Kline, vice president and general counsel; David M. Crawford, secretary; Walter Holyk, chief geologist; Earl L. Huntington, attorney; Richard Clayton, engineer, and Kenneth H. Darke, geologist; no judgment was entered against petitioners Claude O. Stephens, president and director, Charles F. Fogarty, executive vice president and director, or Richard D. Mollison, vice president-exploration.[3] The court

[3] One of the defendants, Francis G. Coates, a director of Texas Gulf, consented to entry of a judgment against him on October 2, 1969, pursuant to a stipulation with the Commission (R. 6412–6420).

On June 22, 1970, a default judgment was entered against another defendant, Thomas P. O'Neill, an accountant who had been employed by Texas Gulf. Petitioners' notice of appeal, which was filed on June 15, 1970, preceded the entry of the default judgment. Since there had not been, as Rule 54(b) of the Federal Rules of Civil Procedure specifies, an "express determination that there [was] no just reason for delay" and there had been no "express direction for the entry of judgment," the order petitioners appealed from, entered on April 16, 1970, appears not to have been a final judgment that is appealable. *Davis* v. *National Mortgage Corp.*, 320 F. 2d 90 (C.A. 2); *G.W.K., Inc.*, v. *Philco Corp.*, 276 F. 2d 928 (C.A. 2); *Partin* v. *Hassan Motors, Inc.*, 363 F. 2d 104 (C.A. 6). See also *Advisory Committee Notes on Rule 54(b)* (1961 Amendments). A premature notice of appeal has been held to be a nullity and without effect. *Studer* v. *Moore*, 153 F. 2d 902, 903 (C.A. 2); *Stevens* v. *Turner*, 222 F. 2d 352 (C.A. 7); *Aberlin* v. *Zisman*, 244 F. 2d 620 (C.A. 1), certiorari denied, 355 U.S. 857. The Commission, without urging dismissal on this ground, brought these facts and authorities to the attention of the court below, which did not comment thereon.

of appeals also held that petitioner Texas Gulf violated Section 10(b) and Rule 10b–5 by failing to exercise due diligence in issuing a misleading press release on April 12, 1964, denying rumors of a "major strike" only four days before the ore strike was formally announced. No judgment was entered against Texas Gulf.

1. THE COMMISSION'S COMPLAINT

On April 19, 1965, the Commission filed a complaint (JA 77a–115a)[4] in the district court alleging that, during the exploratory drilling and before the information contained in the April 16 press release became available to the public, thirteen officers, directors and employees of Texas Gulf, including petitioners, had each committed one or more of the following violations of Section 10(b) and Rule 10b–5:

> 1. Purchased Texas Gulf common stock or calls on that stock on the basis of the results of the drilling without appropriate disclosure.
>
> 2. Divulged information as to drilling results to friends, relatives or business associates for use in their purchases, without appropriate disclosure, of Texas Gulf stock or calls or recommended on the basis of such inside information that they purchase Texas Gulf securities.
>
> 3. Accepted stock options from Texas Gulf while this information as to drilling results was concealed from Texas Gulf's directors.

It also alleged that Texas Gulf had violated Section 10(b) and Rule 10b–5 by the issuance on April 12,

[4] "JA" refers to the joint appendix in the court of appeals, a copy of which has been lodged in this Court.

1964, of a false and misleading press release about the ore deposit.

The complaint requested that the defendants be permanently enjoined from future similar violations of Section 10(b) and Rule 10b–5; that the individual defendants who had violated those provisions by purchasing Texas Gulf stock or calls be required to offer rescission to the sellers; that those who had divulged such information be required to offer restitution to stockholders who had sold Texas Gulf securities to the recipients of the information; and that stock options accepted by the defendants be rescinded (JA 113–115).

2. THE EVIDENCE RELEVANT TO PETITIONERS

In 1963, Texas Gulf was a narrowly-based company deriving 97 per cent of its income from sulphur (JA 1222a). Because of an over-supply of sulphur on the world market, Texas Gulf's sales and earnings had declined from 1955 to 1963, and Texas Gulf was endeavoring to deal with its depressed business by diversifying into related fields. One aspect of this diversification was an exploratory program for base metal sulphides in Canada.[5] (Pet. App. 2a–5a), which, if successful, would open a new area of corporate opportunity for the company (JA 1060a). Up to November 1963, however, the corporation had spent six years and millions of dollars in exploring more than 15,000 square miles of eastern Canada without success (Pet. App. 5a, 8a; JA 1723a).

[5] Sulphides are chemical combinations of sulphur with other elements (Pet. App. 59a n. 2).

Texas Gulf had an option to purchase the northeast quarter section of a square-mile plot of land located near Timmins, Ontario called the Kidd 55 segment (Pet. App. 6a). It had obtained the option after conducting an aerial geophysical survey, confirmed by subsequent geophysical investigations on the ground, indicating the existence of a wide "first class" anomaly [6] measuring some 1000 feet in length (Pet. App. 6a, 8a, 29a).

On November 8 through 12, 1963, Texas Gulf drilled an exploratory drill hole, K–55–1, on this section (Pet. App. 8a). Although the anomaly could have been caused by worthless materials (Pet. App. 59a n. 3), a visual examination of the core recovered from the hole revealed such high copper and zinc values over a length so great—approximately 600 consecutive feet of the core's 657-foot length (Pet. App. 27a–28a)—that four expert witnesses called by petitioners testified they had never seen or heard of a comparable initial exploratory drill hole in a base metal mineral deposit (Pet. App. 76a). Moreover, the mineralization began only 26 feet below the surface of the earth. This drill hole has been described as "one of the most impressive drill holes completed in modern times" (Pet. App. 90a n. 13) and "just beyond your wildest imagination" (Pet. App. 90a).

The "excited" company geologist, Mr. Darke, who had been at the drill site, called from Timmins to his superior Dr. Holyk at his home in Stamford, Connect-

[6] An anomaly is a deviation from the normal in the earth's crust of such physical characteristics as electrical conductivity (R. 665).

icut, on Sunday evening, November 10, to report the initial intersection of copper mineralization (JA 723a–724a, 260a–261a). Within two days this and subsequent reports from the drill site had brought Dr. Holyk, Mr. Mollison and Dr. Fogarty, senior officials of the corporation, from New York to Timmins under conditions of great personal discomfort. There they were able to compare the visual estimates of the mineralization in the core logged by Messrs. Holyk and Darke with the actual core (JA 719a, 723a–724a, 756a–758a, 848a–850a).

As a result of the information thus obtained by the top management of Texas Gulf, security measures were taken to keep the results of the drilling secret so that the corporation could acquire the remainder of the land at favorable prices (Pet. App. 8a–9a; JA 910a–911a, 245a). These measures included an order by Mr. Stephens, the president of the corporation, that no one outside the exploration group, not even the nonmanagement directors, should be told about the drilling results (Pet. App. 47a, 75a). Drilling was suspended and was not resumed until March 31, 1964 (Pet. App. 9a).

During the four and one-half months between November 12, 1963, when K–55–1 was completed, and March 31, 1964, when the drilling was resumed on the Kidd 55 segment, the individual defendants and certain other persons who received "tips" from them purchased Texas Gulf stock and calls thereon. Prior to these transactions "these persons had owned 1135 shares of TGS stock and possessed no calls; there-

after they owned 8235 shares and possessed 12,300 calls" (Pet. App. 76a).[7]

During this period Texas Gulf granted stock options covering 89,950 shares of Texas Gulf stock to officers and employees of the company, including options covering 30,700 shares to petitioners Stephens, Fogarty, Kline, Mollison and Holyk. Pursuant to the secrecy order of the corporation's president (see p. 9, *supra*), who had recommended the granting of the options, the news of Texas Gulf's discovery of copper and zinc in Timmins had been withheld from the members of the incentive stock option committee of the board of directors (JA 329a–330a, 332a–333a, 339a–341a, 362a), which met on February 20, 1964, and recommended the granting of the options (Pet. App. 46a). After the meeting of the committee there was a meeting of the full board, at which time the recommended options were formally granted (Pet. App. 46a). None of the nonmanagement directors knew about the drilling results (Pet. App. 63a n. 16). Mr. Kline, as administrative vice president and secretary, attended both the meeting of the committee and the meeting of the full board (Pet. App. 103a; JA 401a–402a). Although the options were intended to be granted at the fair market value of the underlying stock based upon its current market price (Pet. App. 48a), neither Stephens, Fogarty nor Kline informed the committee or board about the drilling results.

Drilling on the Kidd segment was resumed by Texas Gulf on March 31, 1964, and by Friday, April 10, 1964,

[7] Individual purchases are set forth in chronological order at Pet. App. 70a–71a.

"approximately ⅔ of the ore ultimately found to exist by the time of the preparation of the April 16, 'major strike' release had been discovered by 5 holes placed so as to indicate continuity of mineralization within the large anomaly" (Pet. App. 114a n. 28). By 7:00 a.m. on Monday, April 13, 1964, when Texas Gulf's "gloomy" press release appeared in New York City newspapers (Pet. App. 58a), all but one of the seven holes upon which Texas Gulf based its April 16 announcement that it had made a "major strike" had either been completed or had already encountered mineralization (Pet. App. 8a–12a).[8]

The "gloomy" press release was "designed to quell the rumors" reported in New York newspapers on Saturday, April 11, 1964, respecting the ore discovery by Texas Gulf (Pet. App. 78a). On that day Dr. Fogarty conferred with Mr. Mollison, who had left Timmins the preceding day and returned to his home in Connecticut, and who advised Dr. Fogarty of the drilling results as of 7:00 p.m. April 10 (Pet. App. 53a). On Sunday, April 12, 1964, after the release had been drafted for Monday morning publication, Dr. Fogarty again called Mr. Mollison to see if he had any further information and was told that he did not (Pet. App. 54a). Despite the rapidly developing situation at Timmins (Pet. App. 10a–11a, 59a n. 4), the draftsmen of the release made no effort to determine what had happened at the drill site between Friday evening and

[8] The mineralization encountered by these six holes as of that time amounted to 90 percent of the mineralization announced in the April 16 press release (Pet. App. 114a n. 28).

Sunday afternoon.[9] Dr. Fogarty, the principal draftsman of the release, admitted that he did not want "to take that trouble" to obtain such information (J.A. 863a).

Notwithstanding the fact that none of the "drilling results after 7:00 p.m. on April 10 were known to the framers of the April 12 release" (Pet. App. 57a), the release (Pet. App. 177a–178a), which was issued Sunday afternoon and designed to appear in Monday's papers, spoke in terms of "[t]he drilling done to date" and "work done to date." It labeled the rumors of an ore discovery as "exaggerate[d]" and "without factual basis"; it indicated that any statements about size and grade of ore were "premature and possibly misleading"; it labeled the Kidd 55 segment a "prospect" and indicated that "more drilling would be required for proper evaluation * * *." The release did not give any facts concerning the amount of drilling done nor the results of such drilling.

Stories reflecting the release appeared in the *Wall Street Journal* and other news media on Monday, April 13, 1964, as well as on the Dow Jones broad tape (Pet. App. 188a).[10] The price of Texas Gulf common

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[9] There were no problems with respect to telephone communication between New York and Timmins (JA 774a), and both Messrs. Darke and Clayton were in Timmins on April 12 (Pet. App. 37a; JA 731a).

[10] On the morning of April 13, the day the press release was disseminated to the investing public, Mr. Ackerley, a reporter for *The Northern Miner*, visited the drill site, where Messrs. Mollison, Holyk and Darke were present. Based entirely on the information obtained that morning (Pet. App. 56a; JA 833a–834a), Mr. Ackerley wrote an article that appeared in *The*

stock on the New York Stock Exchange, which had shown a steady rise from $16 a share in November 1963 to $32 a share when it opened on the Exchange on April 13, 1964, closed at 30⅞, and continued to decline in price on April 14 and 15 (Pet. App. 83a).

On the afternoon of April 15, the top management of Texas Gulf decided to hold a press conference the next morning, following a regularly scheduled meeting of the board of directors, to announce the discovery (JA 867a–868a).[11] This method of announcing the major ore discovery was chosen "to get the information to the most stockholders as quickly as it was possible," and because the board considered a press conference to be "the best media [sic] to get maximum coverage to everyone at the same time." (JA 869a–870a). Following the news of the discovery, on substantially increased trading, the price of Texas Gulf common stock on the Exchange closed on April 16, 1964, at 36⅜, seven points over its close of the previous day. By mid-May the stock was trading at more than $58 a share (Pet. App. 83a).

During the period of drilling activity from March 31, 1964, to April 16, 1964, defendants purchased an additional 1860 shares of Texas Gulf stock (Pet. App. 70a). Among these purchases were those made by Messrs. Crawford and Clayton "within 24

Northern Miner on April 16, 1964, which stated that "a major new zinc-copper-silver mine is definitely in the making * * *" and mentioned an indicated ore reserve of more than 10 million tons (Pet. App. 82a, 34a–35a).

[11] This was the first time in at least 14 years that a Texas Gulf directors' meeting was to be followed by a press conference (JA 869a, 847a).

hours before the news of the ore strike was made public" on April 16 (Pet. App. 225a). At the time of their purchases both were aware of the April 12 press release (Pet. App. 99a, 101a) and both knew "beyond peradventure of a doubt" that Texas Gulf "had made a very important mineral discovery" (Pet. App. 197a).

3. THE JUDICIAL DECISIONS

A. The Initial Decisions of the District Court and the Court of Appeals: The Violations [12]

The district court and all the judges of the court of appeals sitting *en banc* agreed that Section 10(b) and Rule 10b–5 prohibit corporate insiders from purchasing their corporation's securities or calls thereon on a national securities exchange when the purchases are made on the basis of material information about the corporation which is not available to the investing public (Pet. App. 20a–24a, 73a–74a, 119a, 128a, 170a). They also agreed that any member of top management who accepted a stock option from a corporation while withholding material information from the directors would also violate Section 10(b) and Rule 10b–5 (Pet. App. 48a–49a, 73a, 119a–121a, 128a, 146a–147a).[13] Furthermore, they agreed that in enforcement actions

[12] Pursuant to a stipulation by all parties the question of the appropriate remedy was deferred pending the initial appeal; therefore the first round of decisions by the district court and the court of appeals dealt with the question whether violations of the Securities Exchange Act had occurred.

[13] Both courts apparently recognized that in granting incentive stock options the directors of the company necessarily rely on information furnished to them by the top management of the corporation (Pet. App. 47a), and that the latter are there-

under Section 10(b) and Rule 10b–5 the Commission need not prove scienter or intent to deceive (Pet. App. 18a–20a, 99a–100a, 119a, 128a, 170a).

INSIDERS PURCHASING TEXAS GULF STOCK AND "TIPPING" OTHERS TO PURCHASE

The district court held that the persons who had purchased stock or calls or had recommended purchase of Texas Gulf stock to others prior to 7:00 p.m. on April 9, 1964, when the court found that there was "real evidence that a body of commercially mineable ore might exist" (Pet. App. 28a–29a), did not violate Rule 10b–5 because in its view the drilling results had not been material up to that time (Pet. App. 33a–34a). While the district judge found that "[t]here was no doubt that the [first] drill core * * * was unusually good and that it excited the interest and speculation of those who knew about it" (Pet. App. 29a), he believed that "* * * the test of materiality must necessarily be a conservative one * * *" and that only long-term, conservative investors were protected against misuse of inside information (Pet. App. 25a–26a). Only Messrs. Clayton and Crawford, who had purchased or placed orders to purchase Texas Gulf securities just prior to the April 16 announcement of a "major strike", were found to have violated Section 10(b) and Rule 10b–5.

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fore "under a duty to inform * * * [them] of material information affecting the issuance of the stock options," including "material information bearing on the market value of * * * [the] stock on that date" (Pet. App. 48a). There were, however, some differences of opinion as to when disclosure would be appropriate (Pet. App. 103a n. 24, 119a–121a, 146a–147a).

The court of appeals, while relying on the trial court's "findings of basic fact" (Pet. App. 89a), rejected that court's "conservative" (Pet. App. 87a–88a) standard of materiality. In determining whether the facts involved here were material, it noted two alternative phrasings of the standard of materiality applicable in Rule 10b–5 cases: "'* * * whether a *reasonable* man would attach importance * * * [to the information] in determining his choice of action in the transaction in question,'" and whether "'* * * in reasonable and objective contemplation [the information] *might* affect the value of the corporation's stock or securities * * *'" (Pet. App. 87a, emphasis in original). It held that all investors, including those with speculative objectives, are entitled to the protection of the Act (Pet. App. 88a), and it ruled that the information about the first drill core was material, since it "might well have affected the price of TGS stock and would certainly have been an important fact to a reasonable, if speculative, investor in deciding whether he should buy, sell, or hold" (Pet. App. 89a).[14]

[14] The court criticized the trial court for disregarding "the only truly objective evidence of the materiality of the K–55–1 discovery"—"the importance attached to the drilling results by those who knew about it" and their "insider trading activity" (Pet. App. 91a). It concluded that "the timing by those who knew of it of their stock purchases and their purchases of *short-term* calls—purchases in some cases by individuals who had never before purchased calls or even TGS stock—virtually compels the inference that the insiders were influenced by the drilling results." The trial court had "made no finding that the insiders were motivated by any factor other than the extraordinary K–55–1 discovery when they bought their stock and their

Accordingly, the court of appeals reversed the district court, holding that those insiders who had purchased Texas Gulf stock or calls thereon, or who had "tipped" others to purchase Texas Gulf stock[15] after November 12, 1963, were in possession of material inside information and therefore, having failed to disclose that information, were in violation of Section 10(b) and Rule 10b–5 (Pet. App. 73a–74a). The court remanded the case to the district court to determine the appropriate remedy (*ibid.*). At the same time the court unanimously affirmed the district court's judgment with respect to Messrs. Crawford and Clayton, who had purchased Texas Gulf stock just prior to the April 16 release (Pet. App. 73a, 170a).

INSIDERS' ACCEPTANCE OF STOCK OPTIONS

With respect to those who received stock options, the district judge found no violations because he viewed the drilling results as not material by February 20, 1964, the date on which the options were granted (Pet.

calls" but had relied "upon what these defense experts said the defendant insiders *ought* to have thought about the worth to TGS of the K–55–1 discovery." *Id.*

For example, Dr. Fogarty, who owned 705 shares of Texas Gulf stock before this period of time (JA 235a), purchased 300 shares of Texas Gulf stock on November 12, 1963, just before he left for Timmins to view the "remarkable" core for himself. (Pet. App. 13a; JA 850a). Following his return, he purchased 700 shares of Texas Gulf stock on November 15, 1963, and 500 shares on November 19, 1963 (Pet. App. 13a). On November 26, 1963, he purchased another 200 shares (Pet. App. 13a).

[15] All nine judges of the court of appeals appeared to agree that the practice of tipping is unlawful, although they differed as to the scope of the prohibition (Pet. App. 86a, 94a n. 16, 170a).

App. 49a). In addition, the court determined that Messrs. Kline, Mollison and Holyk were not members of top management and had no duty to inform the directors of information known by their superiors "since they could assume that such information would be reported" to them by Stephens and Fogarty, the company's top two officials (Pet. App. 48a).

The court of appeals reversed the district court with respect to Messrs. Stephens, Fogarty and Kline, holding that they violated Section 10(b) and Rule 10b-5 because they were in possession of material information when they accepted their stock options, and remanded the case for a determination of the appropriate remedy (Pet. App. 118a). In addition, with respect to Mr. Kline it decided that he was a member of top management [16] (Pet. App. 103a) and that, although he "had no detailed knowledge of the drilling progress * * *" (Pet. App. 102a), he violated his "duty before accepting his option to disclose any material information he may have possessed * * *" (Pet. App. 103a). Mr. Stephens and Dr. Fogarty had surrendered their options and these had been canceled by the company (Pet. App. 102a). The court of appeals on remand instructed the district court to direct rescission of the option granted to Mr. Kline (Pet. App. 118a).

TEXAS GULF'S APRIL 12, 1964, PRESS RELEASE

The trial court held that the press release was not issued "in connection with the purchase or sale of any

[16] The Commission did not appeal the trial court's determination that Messrs. Mollison and Holyk were not members of top management (Pet. App. 103a–104a).

security" within the meaning of Section 10(b) and Rule 10b–5 because there was no "showing that the purpose of the April 12 press release was to affect the market price of TGS stock to the advantage of TGS or its insiders * * *" (Pet. App. 54a). Alternatively, the court concluded that although the drilling results as of 7:00 p.m. April 9, 1964, were material, the press release, while perhaps "gloomy or incomplete," was not misleading or deceptive "on the basis of the facts then known" to Texas Gulf—the drilling results as of 7:00 p.m. April 10, 1964—(Pet. App. 58a). Moreover, without reference to the failure by the company to secure more up-to-date drilling information, the district court found that Messrs. Stephens and Fogarty had "exercised reasonable business judgment under the circumstances" in issuing the release on "the facts then known" (Pet. App. 58a).

Reversing the district court, the court of appeals held that the "in connection with" requirement in Section 10(b) and the Rule is satisfied when "* * * the device employed * * * be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities" (Pet. App. 109a). It further determined that the Commission, which was "charged by Congress with the responsibility of policing all misleading corporate statements" (Pet. App. 111a), need not show that the corporation or those responsible for the corporate statements "engaged in related securities transactions or otherwise acted with wrongful motives" (Pet. App. 109a). To read such a

requirement into the statute it concluded would "render the Congressional purposes ineffective" and "handicap unreasonably the Commission in its work" (Pet. App. 111a). Accordingly, it held (Pet. App. 113a) that

> * * * Rule 10b–5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e.g., by means of the financial media * * * if such assertions are false or misleading or are so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes. * * *

In determining "whether the release was misleading, *i.e.*, whether it conveyed to the public a false impression of the drilling situation at the time of its issuance," the court rejected the district court's test that Texas Gulf was to "be judged *on the facts known to them* when the April 12 release was issued" (Pet. App. 113a, emphasis in original.) The "primary inquiry," in the view of the court of appeals, was "the meaning of the statement to the reasonable investor and its relationship to truth" (Pet. App. 114a).

While several of the court of appeals judges thought that the evidence established as a matter of law that Texas Gulf's April 12, 1964, press release was misleading and that its issuance violated Section 10(b) and Rule 10b–5 (Pet. App. 129a, 121a–122a, 128a), four judges were of the view that they could not "definitively conclude" from the record that it was deceptive or misleading to the reasonable investor (Pet. App. 115a). Accordingly, the district court was di-

rected to determine on remand "the character of the release in light of the facts existing at the time of the release, by applying the standard of whether the reasonable investor, in the exercise of due care, would have been misled by it" (*ibid.*). If so, the district court was to determine not whether Texas Gulf had "exercised 'reasonable *business* judgment under the circumstances'" but whether "the misleading statement resulted from a lack of due diligence on the part of" Texas Gulf (Pet. App. 116a, emphasis in original).

B. The Subsequent Decisions of the District Court and the Court of Appeals: The Appropriate Remedy.

THE INDIVIDUAL DEFENDANTS

On remand, following an evidentiary hearing, the trial court denied all relief against Messrs. Fogarty, Mollison and Stephens, finding that they had surrendered to Texas Gulf at their cost and without profit the stock or stock options they had acquired in violation of Rule 10b–5. The court found that the wide publicity accorded these defendants would serve as an adequate deterrent to future violations (Pet. App. 196a, 211a–212a), for which reason the trial court also refused to enjoin most of the other defendants (Pet. App. 196a–197a). The court issued injunctions, however, against Messrs. Crawford and Clayton, whose violations of Section 10(b) and Rule 10b–5 the court of appeals *en banc* had unanimously upheld (*supra*, p. 17), and who had "* * * purchased during the period of nondisclosure knowing beyond peradventure

of a doubt that TGS had made a very important mineral discovery" (Pet. App. 197a).

Pursuant to the Commission's request for relief other than injunctive, the district court also directed that defendants Darke, Holyk, Huntington and Clayton be deprived of the profits from their purchases of Texas Gulf stock or of calls on Texas Gulf stock on the basis of inside information, and that these profits be paid over to Texas Gulf to be held in escrow (Pet. App. 197a–210a). The court concluded that to do so was in accord with the congressional purpose to "protect the investing public by deterring possible future violations of Section 10(b) and Rule 10b–5" (Pet. App. 203a). Pursuant to the appellate court's instructions to determine the appropriate remedy for defendant Darke's "tipping" of other investors (Pet. App. 74a), the district court distinguished between "those who purchased TGS securities on Darke's recommendation and those who purchased on the recommendation of one of Darke's 'tippees' " and concluded that it would be a "sufficient deterrent" to direct Darke to pay Texas Gulf to hold in escrow "the profits realized by the 'tippees' who purchased on Darke's recommendation * * *" (Pet. App. 206a–207a).

With respect to Mr. Kline, the court refused to enjoin him from violating Section 10(b) and Rule 10b–5 by accepting Texas Gulf stock options while possessing material inside information (Pet. App. 213a). Pursuant to the mandate of the court of appeals, however, it entered judgment against him and directed

that he return his option to Texas Gulf to be cancelled (Pet. App. 212a–213a).

The court of appeals affirmed the judgment of the district court as to the individual defendants except with respect to Mr. Kline.[17] As to the remedy, the court affirmed the Commission's authority, pursuant to Section 21(e) to seek restitution, and an equity court's power, pursuant to Section 27, to grant that remedy as ancillary relief (Pet. App. 226a–230a).

TEXAS GULF'S APRIL 12, 1964, PRESS RELEASE

As to Texas Gulf, the district court, after reviewing the testimony of investor witnesses who had seen reports of the April 12 release in the news media,[18] held

[17] The court reversed the judgment ordering cancellation of Mr. Kline's option and, in effect, confessed error, noting that its prior "unambiguous instruction" ordering cancellation after the parties had specifically deferred the question of remedy deprived Mr. Kline of his day in court on that question (Pet. App. 230a). The case was remanded to the trial court (Pet. App. 231a), where on August 11, 1971, a hearing was held. On September 1, 1971, the trial court, in a memorandum opinion determined that, rather than cancelling his option, Mr. Kline should be deprived of any illegal profits obtained from the exercise of his option. *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, CCH Fed. Sec. L. Rep. ¶ 93,211 (S.D. N.Y., 1971). Judgment was entered on October 4, 1971.

[18] Texas Gulf asserted that it could only be held responsible for "the press release itself, not for the 'inaccurate or incomplete' version carried by the news media" (Pet. App. 188a). However the court rejected this argument stating:

"By issuing the press release 'For Immediate Release,' TGS was depending on the news media to report it to its shareholders. They could not have expected the news media to publish the entire press release, but only those portions which the media deemed important." (Pet. App. 189a). [continued]

"[o]n the basis of the standards laid down by the Court of Appeals," that the press release was "misleading to the reasonable investor using due care" and that "the framers did not exercise due diligence in its issuance" (Pet. App. 188a); therefore, the court ruled that Texas Gulf had violated Section 10(b) and Rule 10b–5. It noted, however, that there was no evidence of any other misleading press releases issued by the company in almost five years since the Timmins discovery, which the court termed a "'once-in-a-lifetime affair,'"; accordingly, it held that there was "no 'proper showing'" of any reasonable likelihood of future violations (Pet. App. 192a), and did not issue an injunction against the company.

The court of appeals held that the finding that Texas Gulf violated Rule 10b–5 "is well-founded and, in our view, unassailable" (Pet. App. 225a). The court concluded that the trial court did not abuse its discretion by allowing the admission of non-expert opinion testimony from investor witnesses, on the ground that their testimony was relevant to "[t]he ultimate issue [of] whether the release was 'misleading to the reasonable investor'" (Pet. App. 222a–223a). It also rejected Texas Gulf's claim that the finding of a violation of Rule 10b–5 for mere negligence in issuing the press

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Moreover, it pointed out:

"the fact that the news media emphasized the words which have been found to be misleading to the reasonable investor merely indicates that the news media also deemed them of importance. The failure of the broad tape to mention that a later statement would be issued indicates only that Dow Jones considered it relatively unimportant." (*Ibid.*)

release infringes its First Amendment rights, holding that Texas Gulf's April 12 report on its drilling progress was "commercial 'factual' speech" and, like other reports submitted by companies under the federal securities laws, was not within the protection afforded by the First Amendment (Pet. App. 224a–225a).

ARGUMENT

The courts below correctly rejected petitioners' narrow reading of Section 10(b) of the Securities Exchange Act and Rule 10b–5, both with respect to the scope of the activities covered and to the commission's remedies available in the event of violation. The court of appeals' holdings on these issues are not in conflict with decisions of other courts of appeals. Nor have petitioners raised any constitutional issues worthy of review. Indeed, although this case resolved several important questions, especially with respect to the use of inside information by corporate officials and a corporation's responsibility for the issuance of its press releases, the results reached by the court of appeals follow logically from the development of the federal securities laws in this area.[19]

More than six years have elapsed since the filing of the Commission's complaint, and more than three

[19] See Jennings, *Insider Trading in Corporate Securities: A Survey of the Hazards and Disclosure Obligations under Rule 10b–5*, 62 Nw. U. L. Rev. 809 (1968); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 Va. L. Rev. 1271 (1965); *Current Policy Issues Involving Inside Information in the Securities Markets*, reprinted in 2 Securities L. Rev. 84 (1970).

years since the initial court of appeals opinion, yet none of the concerns expressed by the corporate and financial communities when the complaint was filed have been realized. There is no evidence, for example, that corporate announcements have been curtailed to the injury of the investing public or that competent corporate officials have left their employment for want of adequate forms of remuneration. Indeed, in general it appears that the business community has adapted its standards of conduct to conform with the principles set forth by the courts below without significant difficulty.[20] Petitioners appear to be more concerned with potential liability arising from private civil damage actions than with any alleged inconvenience to the corporate community: private civil actions, however, raise questions substantially different from those raised in Commission enforcement proceedings, which are brought in the public interest. There is no reason for the Court to address itself to those problems here.

1. We note at the outset that no judgment has been entered against petitioners Texas Gulf, Stephens, Fogarty or Mollison, nor do they contend that the findings[21] of which they complain have any effect in

[20] See *e.g.*, *New York Stock Exchange Company Manual* A-18—A-27 (1968): *American Stock Exchange Company Guide* § 401–406 (1970): see also West, *Timely Disclosure—The View from 11 Wall Street*, 24 Sw. L. J. 241 (1970): see generally, Bromberg, *Disclosure Programs for Publicly Held Companies—a Practical Guide*, 1970 Duke L. J. 1139.

[21] The recitals in the judgment cannot be characterized as a judgment against these petitioners. Cf. *Electrical Fittings Corp.* v. *Thomas & Betts Co.*, 307 U.S. 241, 242.

other actions against them. In these circumstances a party is not normally entitled to review of findings with which he does not agree, unless those findings would constitute *res judicata* or serve as the basis for collateral estoppel. See, *e.g., New York Telephone Company* v. *Maltbie,* 291 U.S. 645; *Partmar Corp.* v. *Paramount Pictures Theatre Corp.,* 347 U.S. 89, 99 n. 6.[22] As to petitioner Kline, the order from which he seeks review remanded his case to the district court for a determination of the appropriate remedy. Judgment was subsequently entered against him on October 4, 1971,[23] but no appeal from that judgment has as yet been taken. The posture of his case is, therefore, comparable to its posture at the time this Court denied his earlier petition. 394 U.S. 976.

2. Petitioners contend (TG Pet. 21, 34–35) that the Commission, in an enforcement action brought

[22] Subsequent cases have not held these findings to be *res judicata* or to have a collateral estoppel effect. See *Fink* v. *Coates,* 323 F. Supp. 988 (S.D. N.Y.), and *Cannon* v. *Texas Gulf Sulphur Co.,* 323 F. Supp. 990 (S.D. N.Y.); see also *Rachal* v. *Hill,* 435 F. 2d 59 (C.A. 5), certiorari denied, 403 U.S. 904. But Cf. *Sullivan* v. *Committee on Admissions and Grievances,* 395 F. 2d 594 (C.A. D.C.).

[23] The district court stated in its opinion on remand:

"Mr. Kline took the stand to stress the borderline nature of his violation and was vigorously cross-examined by the Commission. On the evidence, this Court cannot conclude that Mr. Kline knew less about the discovery than what the Court of Appeals found was sufficient basis for a violation of the Act and of the Rule. Indeed, in view of his trip to Utah with Mr. Fogarty a few days after November 12, 1963 and his responsibilities as General Counsel, it may be that he knew more about the initial drill hole than he originally testified to at the trial." *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* CCH Fed. Sec. L. Rep. ¶93,211 at 91,350.

in the public interest, must prove all the elements of an ordinary damage suit, including scienter, intent to deceive, reliance, and consequent damages. This Court has noted, however, in *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 193, 200, involving an enforcement proceeding under the analogous antifraud provision of the Investment Advisers Act of 1940, 15 U.S.C. 80b–6, that "[i]t is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages" and that "[t]o impose upon the Securities and Exchange Commission the burden of showing deliberate dishonesty as a condition precedent to protecting investors through the prophylaxis of disclosure would effectively nullify the protective purposes of the statute."

Indeed, petitioners' restrictive construction of Section 10(b) of the Securities Exchange Act conflicts with the principle that "securities legislation 'enacted for the purpose of avoiding frauds'" is to be construed "flexibly to effectuate its remedial purposes," without regard to technical and restrictive notions of intent. *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc., supra,* 375 U.S. at 195; see also, *Tcherepnin* v. *Knight*, 389 U.S. 332, 336; cf. *Ellis* v. *United States,* 206 U.S. 246, 257. In passing the Act, Congress recognized that "[s]peculation, manipulation, * * * investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries" were "all a single seamless web * * *" H.R. Rep. No. 1383, 73rd Cong., 2d Sess., 6

(1934). As this Court has recently observed with respect to the quoted congressional language:

> Since practices "constantly vary and where practices legitimate for some purposes may be turned to illegitimate and fraudulent means, broad discretionary powers" in the regulatory agency "have been found practically essential." Id., at 7. Hence * * * Section 10(b) must be read flexibly, not technically and restrictively. Since there was a "sale" of a security and since fraud was used "in connection with" it, there is redress under § 10(b), whatever might be available as a remedy under state law.[24] [Superintendent of Insurance of New York v. Banker's Life and Casualty, No. 70–60, decided Nov. 8, 1971, slip op., pp. 5–6.]

The decision of the court below, in recognizing that the scope of Section 10(b) was intended to be as broad as the Act itself (Pet. App. 92a–93a; 105a–113a), serving as a "catchall" to fill gaps left by more specific provisions,[25] is in accord with the decisions of this Court and other courts of appeals.[26]

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[24] See also, 78 Cong. Rec. 7696 (1934) (Remarks of Rep. Rayburn). The Senate Committee viewed the Securities Act of 1933 and the Securities Exchange Act of 1934 as vesting "in the Securities and Exchange Commission jurisdiction over the source of and traffic in securities." S. Rep. No. 1455, 73d Cong., 2d Sess. 393 (1934).

[25] *Hearings before House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720*, 73d Cong., 2d Sess. 115 (1934); see also H. Rep. No. 1383, 73d Cong., 2d Sess. 6–7 (1934), and S. Rep. No. 792, 73d Cong., 2d Sess. 5–6 (1934).

[26] See *Herpich* v. *Wallace*, 430 F. 2d 792, 806 (C.A. 5); *Rekant* v. *Desser*, 425 F. 2d 872 (C.A. 5); *Kahan* v. *Rosenstiel*, 424 F. 2d 161, 172 (C.A. 3), certiorari denied *sub nom. Glen Alden Corp.* v. *Kahan*, 398 U.S. 950; *Matheson* v. *Armbrust*, 284 F. 2d 670, 674 (C.A. 9). See also *Heit* v. *Weitzen*, 402 F. 2d 909 (C.A. 2), certiorari denied, 395 U.S. 903.

3. The courts below correctly held that the April 12 press release, which was issued to counteract the market effect of newspaper reports (J.A. 853a, 854a, 863a, 866a–867a, 939a), was issued "in connection with" the purchase and sale of securities (Pet. App. 105a–113a). The "in connection with" clause in Section 10(b) has been described as "plainly and—one must assume—intentionally the loosest linkage, in any of the federal antifraud provisions, between a proscribed act and a security transaction."[27] Cf. *Superintendent of Insurance of New York* v. *Bankers Life and Casualty, supra.* As noted by the court below, comparison with the other antifraud provisions in the federal securities laws makes clear "that when Congress intended that there be a participation in a securities transaction as a prerequisite of a violation, it knew how to make that intention clear" (Pet. App. 109a). The Second Circuit's construction of this phrase[28] is consistent with that of other courts.[29]

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[27] Bromberg, *Securities Law: Fraud-SEC Rule 10b–5*, § 7.6(1) at 190.21.

[28] See also *Securities and Exchange Commission* v. *Great American Industries, Inc.*, 407 F. 2d 453 (*en banc*), certiorari denied, 395 U.S. 920; *Heit* v. *Weitzen, supra*, 402 F. 2d 909. But see, *Superintendent of Insurance of New York* v. *Bankers Life and Casualty*, 430 F. 2d 355 (C.A. 2), reversed this Term, No. 70–60, November 1, 1971.

[29] See, *e.g.*, *Herpich* v. *Wallace, supra*, 430 F. 2d 792; *Kahan* v. *Rosenstiel, supra*, 424 F. 2d at 172; *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5), certiorari denied, 365 U.S. 814; *Freed* v. *Szabo Food Service, Inc.*, CCH Fed. Sec. L. Rep. ¶91,317 (N.D. Ill.); *Stockwell* v. *Reynolds & Co.*, 252 F. Supp. 215 (S.D. N.Y.); *Meisel* v. *North Jersey Trust Co.*, 218 F. Supp. 274, 279 (S.D. N.Y.).

The fact that Congress specifically provided for the filing of periodic and other specified reports with the Commission [30] does not imply, as Texas Gulf suggests (TG Pet. 24), that Congress intended that other corporate reports and annoucements be unregulated. One of the basic purposes of the Act was "to insure the maintenance of fair and honest markets" in securities transactions,[31] and as the House Report on the bill stated, "There cannot be honest markets without honest publicity. * * *" [32] Furthermore, the decision below does not, as petitioner Texas Gulf implies (TG Pet. 25), require directors to guarantee the accuracy of every statement which the company makes. The decision requires merely that persons preparing a press release which will affect the market for their corporation's securities use "due diligence" in reporting the facts.

Texas Gulf complains (TG Pet. 26) that the court of appeals' standard [33] for judging the press release—

[30] See Sections 13 and 15(d) of the Act, 15 U.S.C. 78m, 78o(d). The Commission has established a detailed reporting system under these provisions. See Rules 13a–1 to 13b–1, 15d–1 to 15d–21, 17 CFR 240.13a–1 to 240.13b–1, 240.15d–1 to 240.15d–21. It is, of course, implicit in the reporting requirements that the documents filed with the Commission must be complete and accurate.

[31] Section 2 of the Act, 15 U.S.C. 78b.

[32] H. Rep. No. 1383, 73d Cong., 2d Sess. 11 (1934).

[33] In assuming that the court of appeals' standard is based on "the subjective reactions of persons in the market" (TG Pet. 26), petitioners fail to distinguish between the opinion testimony of investor-witnesses, which was relevant to the ultimate issue, and the ultimate issue itself, *i.e.*, whether the re-

"whether the reasonable investor, in the exercise of due care, would have been misled by it" (Pet. App. 115a)—is excessively subjective. In fact, this standard is no more subjective than the reasonable man standard uniformly employed in tort law. See Prosser, *Torts*, 153–168 (Hornbook ed., 1964). Furthermore, the court correctly determined that Texas Gulf's conduct should be judged "in the light of the facts existing at the time of the release" (Pet. App. 115a), and that a finding of violation required also the determination that, in light of these facts, the draftsmen failed to exercise "due diligence" (Pet. App. 116a). The district court's initial finding that "on the basis of the facts known to its draftsmen at the time of its preparation" the press release was an exercise of "reasonable business judgment" (Pet. App. 116a) cannot be equated with a finding of "due diligence" under the court of appeals' test, as Texas Gulf asserts (TG Pet. 26–27). The district court recognized this distinction in finding on remand that "on the basis of the standards laid down by the Court of Appeals * * * the framers of the press release failed to exercise due diligence" (Pet. App. 188a).

4. The court of appeals applied two alternative phrasings of the standard of materiality applicable in Rule 10b–5 cases: that the information is important

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lease was misleading to the reasonable investor (Pet. App. 222a). The Commission offered testimony of investor witnesses solely to buttress its contention that the release on its face was misleading.

to a "reasonable" investor and that "in reasonable and objective contemplation" it might affect the market price of the stock (see p. 16, *supra*).[34] Other courts of appeals have adopted both of these standards.[35] Of

[34] Petitioners argue that the court of appeals correctly stated that a *substantial* prospective market impact is necessary to render inside information material and then departed from this standard by dispensing with the requirement of substantiality (HDC Pet. 13; H. Pet. 9–11). We read the phrase "in reasonable and objective contemplation," used by the court below in this case (Pet. App. 87a) and in its earlier decision cited by petitioners (TG Pet. 21), *List* v. *Fashion Parks, Inc.*, 340 F. 2d 457, 462, (C.A. 2), certiorari denied *sub nom. List* v. *Lerner*, 382 U.S. 811, to exclude matters which might cause insubstantial market fluctuations. Moreover, it is difficult to see how investment judgment could be affected without affecting market value.

[35] *Myzel* v. *Fields*, 386 F. 2d 718, 734 and n. 7 (C.A. 8), certiorari denied, 390 U.S. 951; *Rogen* v. *Ilikon Corp.*, 361 F. 2d 260, 266 (C.A. 1); *Kohler* v. *Kohler Co.*, 319 F. 2d 634, 642 (C.A. 7); accord, *Securities and Exchange Commission* v. *R. A. Holman & Co.*, 366 F. 2d 456, 458, rehearing denied *per curiam*, 377 F. 2d 665 (C.A. 2), certiorari denied, 389 U.S. 991; *List* v. *Fashion Park, Inc.*, *supra*, 340 F. 2d at 462. The Second Circuit has used the first phrasing subsequent to the decision below, with one of the two dissenting judges here joining in the opinion. *Securities and Exchange Commission* v. *Great American Industries, Inc.*, *supra*, 407 F. 2d at 459–466. See also, *e.g.*, *Lehigh Valley Trust Co.* v. *Central National Bank*, 409 F. 2d 989, 993 (C.A. 5); *Northwest Paper Corp.* v. *Thompson*, 421 F. 2d 137, 138 (C.A. 9); *Chasins* v. *Smith, Barney & Co.*, 438 F. 2d 1167, 1171 (C.A. 2). And cf. opinion of Justice Harlan in *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 384, to the effect that a material fact in a proxy statement is one "of such a character that it might have been considered important by a reasonable shareholder who was in the process of deciding how to vote."

the two courts of appeals' decisions which petitioners claim are inconsistent with that of the court below (TG Pet. 31–32), one, *James Blackstone Memorial Library Assn'* v. *Gulf, M. & O. R.R. Co.*, 264 F. 2d 445, 450–451 (C.A. 7), certiorari denied, 361 U.S. 815, is an earlier decision of one of the courts which has since specifically adopted the second phrasing (see n. 35, *supra*), and in any event the undisclosed information involved in that case could not possibly have affected the fair market value of the plaintiff's stock.[36] The other, *Sunray Oil Co.* v. *Helmerich & Payne, Inc.*, 398 F. 2d 447 (C.A. 10), does not articulate any standard of materiality, and there is no indication that the drilling results in that case were in any way comparable to the "remarkable discovery" of Texas Gulf (R. 1717; see pp. 8, 13, *supra*);[37] moreover, two of the three judges who decided *Sunray* specifically held that case inapplicable in *Mitchell* v. *Texas Gulf Sulphur Co.*, 446 F. 2d 90, 100 (C.A. 10), petition for certiorari filed (No. 71–421).

In refusing to limit the concept of "reasonable" investors to whom information might be material to long-term, "conservative" investors, the court of ap-

[36] The undisclosed information concerned the possibility that certain property in the corporation's name might be sold to the government at an advantageous price. All the property of the corporation had already been leased to another party in perpetuity, however, and a sale at large profit would not have affected the guaranteed dividend, which is all that plaintiffs were entitled to receive. 264 F. 2d at 447–448, 450.

[37] Neither of the two well holes in the *Sunray* case was on the land where the company had drilling rights; one was more than a mile away. See unreported findings of fact and conclusions of law in the district court, p. 7, No. 68 C 92 (N.D. Okla.)

peals did not depart from the traditional test of materiality, as Texas Gulf suggests (TG Pet. 31). The Act protects speculators as well as conservative investors. Although one of the purposes of the Act was to curb *excessive* speculation, the House Committee Report stated: "There is plenty of room for legitimate speculation in the balancing of investment demand and supply * * *. No investor, no speculator can safely buy and sell securities upon the exchanges without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells." [38] Certain of the filings with the Commission required under the Securities Act of 1933 relate to securities which would be of interest only to speculators [39] while others describe securities that might appeal to more conservative investors.

Having rejected the test of materiality applied by the district court (see p. 16 *supra*,) the court of appeals in reviewing the district court's decision was not bound, as petitioners contend (HDC Pet. 15–17; H. Pet. 15–17; TG Pet. 36–37), by that court's conclusions as to materiality. This Court has repeatedly held that Rule 52(a) of the Federal Rules of Civil Procedure does not cover findings of fact based upon the application of erroneous legal standards to undisputed eviden-

[38] H. Rep No. 1383, 73d Cong., 2d Sess. 11 (1934).

[39] The Commission has a special registration form for securities of a speculative nature, which must be so labeled. Form S–2, General Instruction D(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶7142, at 6241–6242; see, also, Form S–3, General Instruction E(b), reprinted in 1 CCH Fed. Sec. Law Rep. ¶7152, at 6262.

tiary facts. *E.g., United States* v. *General Motors Corp.*, 384 U.S. 127, 142 n. 16; *United States* v. *Parke, Davis & Co.*, 362 U.S. 29, 44.[40]

5. All of the judges of the court of appeals sitting *en banc*, as well as the district judge agreed that Section 10(b) and Rule 10b–5 prohibit a corporate insider from trading in his corporation's securities on the basis of important inside information not available to the public. This is also the view of all other federal courts that have considered the matter.[41] Contrary to petitioners' argument that they had no "fair warning" as to this meaning of Rule 10b–5 (TG Pet. 38–39), the Commission has repeatedly expressed this interpretation of its rule in formal adjudications,[42] in

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[40] See generally, 5 Moore's *Federal Practice* ¶52.03[3] and 52.04. The fact that other provisions of the securities acts have been interpreted to contain differing definitions of materiality does not affect the applicable standard in this case (see TG Pet. 30). Cf. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 466.

[41] *E.g., Myzel* v. *Fields*, *supra*, 386 F. 2d 718; *List* v. *Fashion Park, Inc.*, *supra*, 340 F. 2d 457, 461–462; *Kohler* v. *Kohler Co.*, *supra*, 319 F. 2d 634; *Reed* v. *Riddle Airlines*, 266 F. 2d 314 (C.A. 5); *Cochran* v. *Channing Corp.*, 211 F. Supp. 239, 242–243 (S.D.N.Y.); *Speed* v. *Transamerica Corp.*, 99 F. Supp. 808 (D. Del.), final judgment awarded, 135 F. Supp. 176 (D. Del.), affirmed as modified, 235 F. 2d 369 (C.A. 3); *Kardon* v. *National Gypsum Co.*, 73 F. Supp. 798 (E.D. Pa.), modified in other respects, 83 F. Supp. 613 (E.D. Pa.); *Mansfield Hardwood Lumber Co.* v. *Johnson*, 268 F. 2d 317, 319 n. 3 (C.A. 5) (dictum), certiorari denied, 361 U.S. 885; cf. *Strong* v. *Repide*, 213 U.S. 419, 431; and *Diamond* v. *Oreamuno*, 24 N.Y. 2d 494, 301 N.Y.S. 2d. 78.

[42] The first opinion by the Commission under Rule 10b–5 was issued "to call attention" to the rule and to the Commission's view that it was a violation for insiders, without disclosing a

enforcement actions in the courts,[43] in *amicus curiae* briefs in private actions,[44] and in pamphlets describing its activities to the public and reports to Congress.[45]

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plan to liquidate the corporation at a large premium over the market price of the stock, to cause their corporation to purchase its stock from the minority public shareholders, thereby increasing the value of the insiders' holdings "almost to the same extent as if they had purchased such shares for themselves." *Ward LaFrance Truck Corp.*, 13 S.E.C. 373, 374, 376, 381; *accord*, *R. D. Bayley & Co.*, 19 S.E.C. 773, 784; *Hughes & Treat*, 22 S.E.C. 623, 626 (dictum); *Cady, Roberts & Co.*, 40 S.E.C. 907.

[43] *E.g.*, *Securities and Exchange Commission* v. *First Investment Co.* D.N.H. (Litigation Release No. 281, June 20, 1945); *Securities and Exchange Commission v. Boyd Transfer & Storage Co.* (D. Minn.) (Litigation Release No. 295, Aug. 20, 1945; Litigation Release No. 308, Dec. 7, 1945); *Securities and Exchange Commission* v. *Gentile* (S.D. N.Y.) (Litigation Release No. 323, Feb. 12, 1946); *Securities and Exchange Commission* v. *Redfield* (D. Mass.) (Litigation Release No. 899, Feb. 24, 1955); *Securities and Exchange Commission* v. *Aldred Investment Trust* (S.D. N.Y.) (Litigation Release No. 2081, Aug. 11, 1961). These actions were settled when the violators consented to injunctive relief and, in at least some cases, agreed to make restitution.

[44] *E.g.*, Memorandum of the Commission, *Amicus Curiae*, p. 3, Reply Memorandum of the Commission, *Amicus Curiae*, pp. 4–17, and the Supplemental Reply Memorandum of the Commission, pp. 7–16, in *Speed* v. *Transamerica Corp.*, *supra*, 99 F. Supp. 808.

[45] Securities and Exchange Commission, Work of the Securities and Exchange Commission 8 (1951, 1952, 1954 eds.), 9 (1957, 1960, 1961, 1962, 1964, 1965, 1966 eds.) (title varied in 1964 and 1965 eds.); Securities and Exchange Commission, Thirteenth Annual Report 63–64 (1947), Fifteenth Annual Report 72 (1949); see also "Study of Securities and Exchange Commission," *Hearings Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 82d Cong., 2d Sess. 723–726 (1952).

Petitioners do not appear to contend that the corporate employees in question here are not "insiders" as that term has been used in the context of Section 10(b),[46] or that a corporate official, who cannot himself purchase stock without disclosure, may give tips on the basis of the same material information to friends, relatives and business associates so that they can use the information in securities transactions without disclosure.[47] They argue (TG Pet. 33), however, that "[t]he legislative history clearly demonstrates that, absent a showing of fraud or deceit,

[46] The trial court's holding that "insiders subject to the disclosure requirements of Section 10(b) and Rule 10b–5 may include employees as well as officers, directors, and controlling stockholders who are in possession of material undisclosed information obtained in the course of their employment" (Pet. App. 23a) was unanimously upheld by the court of appeals (Pet. App. 85a–86a, 119a, 128a, 170a). Accord, *e.g.*, *Ross* v. *Licht*, 263 F. Supp. 395 (S.D.N.Y.); 3 Loss, *Securities Regulation* 1450–1454 (2d ed. 1961); Fleischer, *Securities Trading and Corporate Information Practices: The Implications of the Texas Gulf Sulphur Proceeding*, 51 Va. L. Rev. 1271, 1280–1282 (1965).

[47] Petitioner Darke, who was found to have violated Section 10(b) and Rule 10b–5 for tipping, does not appear to contend that such a tip would be lawful if given with knowledge that the information was not available to the investing public. See *Kuehnert* v. *Texstar Corp.*, 412 F. 2d 700 (C.A. 5); *Wohl* v. *Blair & Co.*, 50 F.R.D. 89 (S.D.N.Y.); *Ferraioli* v. *Cantor*, 281 F. Supp. 354 (S.D.N.Y.); *Ross* v. *Licht*, 263 F. Supp. 395 (S.D.N.Y); *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CCH Fed. Sec. L. Rep. ¶77,629 (S.E.C.); cf. *Investors Management Co., Inc.*, CCH Fed. Sec. L. Rep. ¶78,163 (S.E.C.); *Blyth & Co.*, CCH Fed. Sec. L. Rep. ¶77,647 (S.E.C.); *Herbert L. Honohan* 13 S.E.C. 754, 757–758, modified in other respects, 16 S.E.C. 297; 3 Loss, *Securities Regulation*, *supra*, 1450–1451. See also, *Mosser* v. *Darrow*, 341 U.S. 267, 271–272.

Section 16(b) was designed to be the sole prohibition against insider trading." Section 16(b) provides that a corporation may recover profits realized in short-swing transactions by directors, officers and large stockholders of the corporation regardless of whether they have traded on inside information. As the district court noted at length, there are significant differences between Section 10(b) and Section 16(b) and the provisions of the latter impose no limitation on the former (Pet. App. 20a–26a). Cf. *Securities and Exchange Commission* v. *Chenery Corp.*, 318 U.S. 80, 91; *Securities and Exchange Commission* v. *National Securities Inc., supra,* 393 U.S. at 465–466. Furthermore, the fact that Congress deleted from an early draft of what became Section 16(b) certain other provisions relating to insider trading does not indicate any lack of concern for the abuse in question here.[48]

[48] The original bills introduced in Congress not only provided for the recovery of profits from short-swing transactions but also outlawed purchases made with intent to engage in short-swing transactions as well as tips of inside information and provided for the recovery by the corporation of profits from tips. H.R. 7852. S. 2693, § 15(b), 73d Cong., 2d Sess. (1934). At the hearings it was indicated that as written these provisions involved difficult problems of interpretation and proof. *Hearings Before the House Committee on Interstate and Foreign Commerce on H.R. 7852 and 8720*, 73d Cong., 2d Sess. 133–138 (1934); *Hearings Before the Senate Committee on Banking and Currency on S. Res. 84 (72d Con.) and S. Res. 56 and 97 (73 Cong.)* 73d Cong., 1st and 2d Sess. 6556–6561, 6954–6955 (1934); *Blau* v. *Lehman*, 368 U.S. 403, 412 n.12; *Smolowe* v. *Delendo Corp.*, 136 F. 2d 231, 236 (C.A. 2), certiorari denied, 320 U.S. 751. Thus, the subsequent versions of the bills reported out in both houses omitted these provisions,

As the court of appeals noted (Pet. App. 86a n. 9), the legislative history indicates that "Congress intended by the Exchange Act to eliminate the idea that the use of inside information for personal advantage was a normal emolument of corporate office." Indeed, the Senate Report stated: "Among the most vicious practices unearthed * * * [in the legislative hearings] was the flagrant betrayal of their fiduciary duties by directors and officers of corporations who used their positions of trust and the confidential information which came to them in such positions, to aid them in their market activities."[49] This legislative history indicates that the power delegated to the Commission in Section 10(b) to define "any manipulative or deceptive device or contrivance" includes the power to prohibit a wide range of abuses in the area of insider trading.

Petitioners imply (TG Pet. 34) that the use of inside information for trading activities should not be unlawful if those activities are carried out in an anonymous exchange market. Such a limitation, as the Second Circuit has previously indicated, "would be

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and the House version even omitted what is now Section 16(b). H.R. 9323, § 15, S. 3420, § 16, 73d Cong., 2d Sess. (1934); the Senate version of what is now Section 16 was accepted in conference, H.R. Rep. No. 1838, 73d Cong., 2d Sess. 35–36 (1934), and enacted, apparently on the premise that the imposition of liability without any showing of abuse of inside information went beyond even the broad rulemaking powers given to the Commission.

[49] S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934). This language is contained in the section of the report dealing with "Market Activities of Directors, Officers, and Principal Stockholders of Corporations."

contrary to the intent of Congress, as set forth in Section 2 of the Securities Exchange Act, 15 US.C. § 78b, which was to regulate 'transactions in securities as commonly conducted upon securities exchanges [as well as] over-the-counter markets.'" *List* v. *Fashion Park, Inc., supra,* 340 F. 2d at 462.[50] Indeed, disclosure is perhaps most important in impersonal transactions, such as those carried out on a stock exchange, because the stockholder who deals with an insider on a face-to-face basis has an opportunity to make informal inquiry whether the insider is in possession of any material information not available to the public.[51] As the court of appeals pointed out, abuse of inside information allows insiders to obtain "secret corporate compensation * * * at the expense of the uninformed investing public * * *. Such inequities based upon unequal access to knowledge should not be shrugged off as inevitable in our way of life, or, in

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[50] The *List* opinion also answered petitioners' contention that purchases of stock on a national securities exchange on the basis of material inside information do not induce other investors to sell their stock at that time (TG Pet. 34–35), pointing out that the concept of reliance is not limited to a situation in which the investor

> actively relied on the silence of the defendant, either because he consciously had in mind the negative of the fact concealed, or perhaps because he deliberately put his trust in the advice of the defendant. * * * The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. * * *

340 F. 2d at 463. Accord, *Myzel* v. *Fields, supra,* 386 F. 2d at 735.

[51] Cf. *Broffe* v. *Horton,* 172 F. 2d 489, 494 (C.A. 2).

view of the congressional concern in this area, remain uncorrected" (Pet. App. 92a–93a).

6. With respect to the question of remedy, petitioners contend that in a suit brought by the Commission, the district court could grant no more than an injunction and that it was without power to order restitution and other relief (HDC Pet. 12–20; TG Pet. 40–41). This Court has held, however, that the grant of jurisdiction in Section 27 of the Securities Exchange Act permits the courts to grant appropriate remedies to effectuate the purposes of the Act and to deter future violations thereof. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386; *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433–435; accord, *Deckert* v. *Independence Corp.*, 311 U.S. 282; cf. *Textile Workers Union* v. *Lincoln Mills*, 353 U.S. 448. In other contexts the Court has upheld the power of the government to seek, and the courts to grant, restitution as an ancillary remedy in spite of the absence in the statutory language of "affirmative confirmation of the power to order reimbursement." *Mitchell* v. *DeMario Jewelry*, 361 U.S. 288, 291–292; accord, *Porter* v. *Warner Holding Co.*, 328 U.S. 395; see also *Sullivan* v. *Little Hunting Park*, 396 U.S. 229, 239; *Jones* v. *Alfred H. Mayer Co.*, 392 U.S. 409, 414 and n. 13. In fact, the court may grant restitution even though injunctive relief is neither sought nor granted. See *United States* v. *Moore*, 340 U.S. 616, 620, n. 6.[52]

[52] Section 21(e) of the Act, which refers only to injunctive relief, does not limit the Commission's authority to invoke the courts' general equity powers to afford complete relief. See *e.g.*, *Lankenau* v. *Coggeshall & Hicks*, 350 F. 2d 61 (C.A.

"An order of restitution is not a judgment for damages or for penalties. It compels compliance and is restorat[ive] of the status quo which falls within the recognized power of a court of equity." *Bowles* v. *Skaggs,* 151 F. 2d 817, 821 (C.A. 6); accord, *e.g., Mitchell* v. *DeMario Jewelry, supra,* 361 U.S. at 293; *Schine Chain Theatres, Inc.* v. *United States,* 334 U.S. 110, 128. Petitioners here were "merely deprive[d] * * * of the gains of their wrongful conduct" (Pet. App. 228a–229a).[53] *Ibid.* Indeed, the formula employed by the court permitted petitioners to retain profits accruing after April 17, 1964 (the day following the announcement that Texas Gulf had a "major strike"). With respect to Mr. Darke, who was held liable for the profits of his tippees, the court recognized that "more of a hardship is imposed" on

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2); *Los Angeles Trust Deed & Mortgage Exchange* v. *Securities and Exchange Commission,* 285 F. 2d 162, 181–182 (C.A. 9), certiorari denied, 366 U.S. 919; see generally J. W. Wade and R. D. Kamenshine, *Restitution for Defrauded Consumers: Making the Remedy Effective Through Suit by Governmental Agency,* 37 Geo. Wash. L. Rev. 1031, 1048–1056 (1969). Indeed, the Commission has obtained restitution or rescission in other cases. See, *e.g., Securities and Exchange Commission* v. *Golconda Mining Co.,* CCH. Fed. Sec. L. Rep. ¶93,058 (S.D. N.Y.); *Securities and Exchange Commission* v. *Wong,* 252 F. Supp. 608, 613–614 (D.P.R.). This is consistent with *Securities and Exchange Commission* v. *C. M. Joiner Leasing Corp.,* 320 U.S. 344, 350–351, where this Court declined to invoke the concept of *expressio unius est exclusio alterius* to limit the scope of securities legislation.

[53] The court of appeals rejected petitioners' contentions that a penalty was involved because under the judgment Texas Gulf might retain the fund even though it was not damaged

him,[54] but "without such a remedy, insiders could easily evade their duty to refrain from trading on the basis of inside information"[55] since the transaction "could be concluded by a relative or an acquaintance * * * or implied understandings could arise under which reciprocal tips between insiders in different corporations could be given" (Pet. App. 229a). Cf. *Mosser* v. *Darrow*, 341 U.S. 267, 271–272.[56]

7. Finally petitioners make a number of constitutional and procedural arguments which we submit are without merit. Texas Gulf contends that the court of appeals' determination that the issuance of a false press release may violate Section 10(b) of the Securities Exchange Act contravenes the First Amendment (TG Pet. 27–30). In *Donaldson* v. *Read Magazine,*

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by this breach of fiduciary duty (Pet. App. 229a–230a). "[T]he primary concern, in a case such as this, is not to determine whether the corporation has been damaged but to decide, as between the corporation and the defendants, who has a higher claim to the proceeds derived from the exploitation of the information." *Diamond* v. *Oreamuno*, *supra*, 24 N.Y. 2d at 498, 499, 301 N.Y.S. 2d at 81–82. Nevertheless, the corporation, which has "a great interest in maintaining a reputation of integrity, an image of probity, for its management and in ensuring the continued public acceptance and marketability of its stock," is injured by their conduct. *Ibid.*

[54] The district court did not charge Mr. Darke with the profits of his tippees' tippees and the Commission did not appeal from that ruling (Pet. App. 206a–207a).

[55] Section 20(b) of the Act, 15 U.S.C. 78t(b), specifically makes it "unlawful for any person, directly or indirectly, to do any act or thing which it would be unlawful for such person to do under * * * [the Act] through or by means of any other person."

[56] The district court did not abuse its discretion in enjoining Messrs. Crawford and Clayton since, as the court of appeals noted, there was "sufficient distinction in [their] cases for the district court to single them out" (Pet. App. 225a).

Inc., 333 U.S. 178, 190, however, this Court stated that the "governmental power" utilized in the Securities Exchange Act and other specified antifraud statutes in making false statements unlawful "has always been recognized in this country and is firmly established." *Donaldson* upheld the validity of an order depriving respondents "of a right to speak or print * * * to the extent necessary to protect others from * * * fraudulent artifices." 333 U.S. at 191. While a tolerance for negligence by conduits of information and topical views (such as newspapers and pamphleteers) may be necessary to assure a free flow of ideas,[57] the protection of the investing public from material misstatements by corporate officials affecting the market value of the corporation's publicly-traded stock clearly outweighs any "right" of these officials to make public statements without exercising due diligence in determining their accuracy.[58] Accordingly,

[57] See, *e.g.*, *New York Times Co.* v. *Sullivan*, 376 U.S. 254, 278–279; *Rosenbloom* v. *Metromedia, Inc.*, 403 U.S. 29.

[58] Some courts have questioned whether commercial speech, such as that involved here, involves issues "about which information is needed or appropriate to enable the members of society to cope with the exigencies of their period," *Thornhill* v. *Alabama*, 310 U.S. 88, 102, as Texas Gulf asserts (TG Pet. 29). See, *e.g.*, *Valentine* v. *Chrestensen*, 316 U.S. 52; *New York State Broadcasters Assoc.* v. *United States*, 414 F. 2d 990, 996–997 (C.A. 2), certiorari denied, 396 U.S. 1061 *Banzhaf* v. *Federal Communications Commission*, 405 F. 2d 1082, 1101–1102 (C.A. D.C.), certiorari denied *sub nom. Tobacco Institute* v. *Federal Communications Commission*, 396 U.S. 842; cf. *Curtis Publishing Co.* v. *Butts*, 388 U.S. 130, 150; *Breard* v. *City of Alexandria*, 341 U.S. 622, 642; *Murdock* v. *Pennsylvania*, 319 U.S. 105, 110–111; *Martin* v. *City of Struthers*, 319 U.S. 141, 142 n.1.

the court below correctly held (Pet. App. 224a-225a) that, in balancing unfettered corporate or commercial speech against injury to the public resulting from misleading or fraudulent corporate press releases, such commercial speech is not entitled to constitutional immunity. *Securities and Exchange Commission* v. *Wall Street Transcript Corp.*, 422 F. 2d 1371, 1379–1380 (C.A. 2), certiorari denied, 398 U.S. 958. See also, *United States* v. *Amick*, 439 F. 2d 351, (C.A. 7), certiorari denied, No. 70–134, Oct. 12, 1971; *Securities and Exchange Commission* v. *May*, 229 F. 2d 123 (C.A. 2); *Halsted* v. *Securities and Exchange Commission*, 182 F. 2d 660, 668 (C.A.D.C.).

Petitioners argue that in contravention of "the Fifth Amendment and well-settled principles of administrative procedure" (TG Pet. 38; H Pet. 18; HDC Pet. 23; C Pet. 26-27), Rule 10b–5 afforded them insufficient warning of the conduct it proscribes. But, as we have pointed out (pp. 36–37, *supra*), the prior consistent administrative and judicial interpretations of that rule furnished petitioners with ample notice that the rule proscribed the activities they engaged in. Cf. *Jordan* v. *DeGeorge*, 341 U.S. 223, 231–232. Where deceptive activity is involved, this Court has warned that "to define strictly the species or evidences of it," would result in jurisdiction over such activity being "perpetually eluded by new schemes which the fertility of man's invention would contrive." [59] Moreover,

[59] *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, *supra*, 375 U.S. at 193 n. 41, quoting from letter of Lord Hardwicke to Lord Kames, dated June 30, 1759.

this Court has recognized that "the choice made between proceeding by general rule or by individual, *ad hoc* litigation is one that lies primarily in the informed discretion of the administrative agency." *Securities and Exchange Commission* v. *Chenery Corp.*, 332 U.S. 194, 203.[60]

Petitioners also argue (C Pet. 12; TG Pet. 41; H Pet. 19) that they were entitled to oral argument after the lower court determined to decide the case *en banc*. On May 2, 1968, three months prior to its decision in this case, the court of appeals advised the parties that "* * * the appeal [would] be considered in banc by all the active judges of the Court upon the record and the briefs [t]heretofore filed, and the opinions written by the judges who heard the argument of the appeal, without further argument" (C.A. 2, Docket No. 30882). No motion for leave to present additional oral argument was made by any of the parties at that time. Thus even if petitioners had a right to be heard orally by the full panel of court below, it would appear that they waived this right. In any event, no such "right" (C. Pet. 19) is an element of due process. *Federal Communications Commission* v. *WJR*, 337 U.S. 265, 275. Nor does Section 46(c) of Title 28 of the United States Code or the Federal Rules of Appellate Procedure, upon which petitioners rely (C.

[60] Cf. *National Labor Relations Board* v. *Wyman-Gordon Co.*, 394 U.S. 759, 771–772 (opinion of Mr. Justice Black); *Columbia Broadcasting System* v. *United States*, 316 U.S. 407, 421. As this Court made clear in *Chenery*, *supra*, the fact that proceeding by litigation "might have a retroactive effect" is "not necessarily fatal to its validity." 332 U.S. at 203.

Pet. 12–22), provide that parties have a "right" to oral argument before the full court. This Court has repeatedly stated that:

> § 46(c) is not addressed to litigants. It is addressed to the Court of Appeals. It is a grant of power. It vests in the court the power to order hearings *en banc*. It goes no further. * * * [61]

While Rule 34 of the Federal Rules of Appellate Procedure provides for oral argument, Rule 2 authorizes a court of appeals to "suspend the requirements or provisions of any of these rules in a particular case * * * on its own motion and [to] order proceedings in accordance with its direction."

Petitioner Crawford also urges (C Pet. 30–32) that the use of the words "material" and "disclosed" in the permanent injunction entered against him are unconstitutionally "vague" and "subjective." In support of this contention he points to purported differences between the court of appeals and the district court in deciding what was material in this case. There was no such difference, however, with respect to the activities of Mr. Crawford, who knew that the April 16 press release that was about to be issued contained material information which had not been disclosed publicly when he made his purchases of

[61] *Western Pacific R.R. Corp.* v. *Western Pacific R.R. Co.*, 345 U.S. 247, 250. This language was quoted in *Shenker* v. *Baltimore & Ohio R.R. Co.*, 374 U.S. 1, 4–5, where it was held that a court of appeals' rule limiting *en banc* consideration only where voted by *each* of the active circuit judges would be sustained despite the language in the statute to the effect that "a hearing or rehearing before the court in banc * * *" might be "ordered by a majority of the [active] circuit judges * * *."

Texas Gulf shares (see pages 13–14, *supra*). By virtue of the *en banc* opinion of the court of appeals, Mr. Crawford has at least as much guidance as to the appropriate meaning of the word "material" as he would have with respect to the application of that word in federal criminal statutes dealing with perjury and false filings. See 18 U.S.C. 1621 and 1001.

The additional constitutional arguments raised by various of the individual petitioners (HDC Pet. 22–23) are based on the assumption that the relief granted by the district court constituted a penalty. As we have seen, pages 43–44, *supra,* this is not so.

CONCLUSION

For the foregoing reasons, the petitions for writs of certiorari should be denied.

Respectfully submitted.

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IN THE

Supreme Court of the United States

October Term, 1971

No. 71-327

TEXAS GULF SULPHUR COMPANY, a Texas Corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, CLAUDE O. STEPHENS and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITIONERS' REPLY BRIEF

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TABLE OF CONTENTS

	PAGE
Introductory Statement	1
I—The Issues Involved Are Properly Before This Court	2
II—This Court's Supervisory Power Should Be Exercised in This Proceeding	5
III—The Press Release Issues	8
IV—The Conflicting and Erroneous Materiality Tests Applied Below	13
V—Petitioners Did Not Have the Required Fair Warning	16
Conclusion	19

TABLE OF AUTHORITIES

Cases:

Associated Press v. Taft-Ingalls Corp., 323 F.2d 114 (6th Cir. 1963)	2n
Banzhaf v. FCC, 405 F.2d 1082 (D.C. Cir. 1968), *cert. denied sub nom.*, Tobacco Institute v. FCC, 396 U.S. 842 (1969)	11
Curtis Gallery & Library, Inc. v. United States, 388 F.2d 358 (9th Cir. 1967)	2n
Donaldson v. Read Magazine, Inc., 333 U.S. 178 (1948)	11

PAGE

Foman v. Davis, 371 U.S. 178 (1962) 3n
Frankfort Oil Co. v. Snakard, 279 F.2d 436 (10th Cir. 1960), *cert. denied,* 364 U.S. 920 (1960) 2n

General Time Corp. v. Padua Alarm Systems, Inc., 199 F.2d 351 (2d Cir. 1952), *cert. denied,* 345 U.S. 917 (1953) 3n

Hamilton-Brown Shoe Co. v. Wolf Bros. & Co., 240 U.S. 251 (1916) 4
Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970) 9, 10

Jordan v. DeGeorge, 341 U.S. 223 (1951) 17

Kahan v. Rosensteil, 424 F.2d 161 (3rd Cir. 1970), *cert. denied sub nom.,* Glen Alden Corp v. Kahan, 398 U.S. 950 (1970) 10

Lemke v. United States, 346 U.S. 325 (1953) 3n
Luckenbach S.S. Co. v. United States, 272 U.S. 533 (1926) 3n

Marotta v. Milestone, 314 F.2d 242 (D.C. Cir. 1963) 2n

SEC v. May, 229 F.2d 123 (2d Cir. 1956) 11
SEC v. National Securities, Inc., 393 U.S. 453 (1969) 14
Sullivan v. Committee on Admissions & Grievances, 395 F.2d 954 (D.C. Cir. 1968) 3n
Superintendent of Insurance of New York v. Bankers Life and Casualty, Docket No. 70-60, Nov. 1, 1971 10

United States v. Amick, 439 F.2d 351 (7th Cir. 1971), *cert. denied,* No. 70-134 (Oct. 12, 1971) 11

United States v. Kokin, 365 F.2d 595 (3rd Cir. 1966), *cert. denied,* 385 U.S. 987 (1966) 3n

PAGE

Statutes and Rules:

Administrative Procedure Act, 5 U.S.C. §1002 18

Investment Company Act of 1940 (15 U.S.C. §80-a-1) 14n

Securities Act of 1933, 15 U.S.C. §77a, *et seq.* 8, 14, 15

Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq.*

Section 10(b), 15 U.S.C. §78j(b) .....*passim*
Section 12, 15 U.S.C. §78l 10
Section 13, 15 U.S.C. §78m 10
Section 14, 15 U.S.C. §78n 10
Section 15, 15 U.S.C. §78o 18
Section 16, 15 U.S.C. §78p 10

SEC Rules and Regulations

Regulation S-X, Rule 210.1002(g) (17 C.F.R. §210.1-02(g)) 14n
Regulation C, Rule 405 (17 C.F.R. §230.405(l)) 14n
Rule 10b-5 (17 C.F.R. §240.10b-5) .....*passim*
Rule 12b-j (17 C.F.R. §240.12b-2(j)) 14
Rule 8b-2 (17 C.F.R. §270.8b-2) 14n

United States Constitution, Amendment No. 1 11–12

Other Authorities:

Berle, A. A., Jr., *The 20th Century Capitalist Revolution* (1954) 13

Bromberg, *Financial Analysts Journal* 30 (Mar.-Apr. 1969) 13, 15

Review of Securities Regulation (Nov. 8, 1971) 13

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v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

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PETITIONERS' REPLY BRIEF

Introductory Statement

The Commission has acknowledged the significance of the case from which this petition arises, but would avoid review by claiming that the issues were correctly decided by the Court of Appeals. The Court will recognize that the Brief in Opposition (hereafter "SEC Br.") is, in reality, a brief on the merits of the Commission's case against petitioners. But only a full briefing and argument can properly apprise the Court of the proceedings below,

and of a record which these petitioners contend supports the initial decision rendered by an experienced and conscientious trial judge after four weeks of trial and after full consideration of the testimony of numerous factual and expert witnesses and hundreds of exhibits. We urge this Court to grant such full review, not only in justice to petitioners, but also to settle important questions of federal law which have never been decided by this Court and which are principally contained in the majority and minority opinions filed in 1968 in the Second Circuit Court of Appeals after *en banc* consideration (66a-171a).

I

The Issues Involved Are Properly Before This Court.

The contention of respondent that this Court is without jurisdiction emphasizes its extreme reluctance to have this case considered on the merits. In the court below it sought to strike the appeal from Judge Bonsal's judgment, and the same contentions are now made in an attempt to thwart review.

Respondent first argues that petitioners' notice of appeal from the judgment of the District Court was filed prematurely. The contention is without merit.* But even

* *Marotta* v. *Milestone*, 314 F.2d 242 (D.C. Cir. 1963); *Frankfort Oil Co.* v. *Snakard*, 279 F.2d 436, 438 (10th Cir.), *cert. denied*, 364 U.S. 920 (1960). Indeed, respondent itself signed a stipulation recognizing the validity of the notice of appeal and thus is estopped from challenging it at this time. *Associated Press* v. *Taft-Ingalls Corp.*, 323 F.2d 114, 116 (6th Cir. 1963). Such stipulation of course gave ample notice to respondent of the appeal. See, *e.g.*, *Curtis Gallery & Library, Inc.* v. *United States*, 388 F.2d 358, 360 (9th Cir. 1967).

if this claim were to be credited, it goes to the question of the Second Circuit's jurisdiction, not to the jurisdiction of this Court. The petition for certiorari was timely filed in this Court. The claim of alleged prematurity was fully briefed and argued before the court below. That court, however, considered the case on the merits, thereby rejecting respondent's contention.*

Respondent also claims that petitioners Texas Gulf, Fogarty, Mollison and Stephens cannot maintain this appeal because no relief was ordered against them in the judgment entered below. Again, this argument was fully briefed and argued before the Court of Appeals which rejected it and rendered its decision on the merits.** More-

* Such rejection was in full accord with this Court's consistent and clear admonitions that technicalities should not be used to oust the jurisdiction of an appellate court. See *Foman* v. *Davis*, 371 U.S. 178 (1962). *Cf. General Time Corp.* v. *Padua Alarm Systems, Inc.*, 199 F.2d 351 (2d Cir. 1952) (concurring opinion), *cert. denied*, 345 U.S. 917 (1953). The hypertechnicality of respondent's argument is further underlined in that the complaint is not of a late-filed notice of appeal but of an allegedly premature one. This Court and numerous circuit courts have repeatedly refused to countenance such arguments. *Luckenbach S.S. Co.* v. *United States*, 272 U.S. 533 (1926); *Lemke* v. *United States*, 346 U.S. 325 (1953); *accord*: *U.S.* v. *Kokin*, 365 F.2d 595 (3rd Cir.), *cert. denied*, 385 U.S. 987 (1966).

** The reasons for the result are plain, for these petitioners are clearly parties aggrieved by the proceedings below. They have been the subject of four well-publicized opinions of federal courts which have finally resulted in findings that they violated Section 10(b) and Rule 10b-5. The judgment below does not dismiss the complaint, as prayed for by petitioners; rather it recites findings of violation and retains jurisdiction in the District Court. In addition, the opinion below, and the record on the docket of the Clerk of the District Court, provides that "if any of the defendants not here enjoined should again violate Section 10(b) and Rule 10b-5 the remedy of injunction in addition to other remedies would be appropriate." (213a-214a). The case is not unlike *Sullivan* v. *Committee on Admissions & Grievances*, 395 F.2d 954 (D.C. Cir. 1968), where a warning rather

over, this Court has even greater reason to entertain this case as the petition for certiorari opens for review the first decision of the Court of Appeals. See *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.*, 240 U.S. 251 (1916). The first decision of the Second Circuit reversed a judgment dismissing the complaint against these four petitioners; they were certainly "parties aggrieved" by that decision.

As to petitioner Kline, respondent contends that the decision below is not final. Lack of finality would not, of course, deprive this Court of its power to review. The only issue as to Mr. Kline that was not resolved by the judgments appealed from concerns the basis upon which the District Court imposed the penalty against Mr. Kline.* The substantive question of whether Kline violated Section 10(b) was finally determined by the Second Circuit in the decisions here sought to be reviewed. Moreover, the ques-

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than other discipline was issued to a lawyer after a finding of violation of the Canons of Ethics. The Court of Appeals upheld defendant's right to appeal:

> "However, the District Court has determined that Appellant was guilty of proscribed conduct and this determination plainly reflects adversely on his professional reputation. In a sense Appellant's posture is not unlike that of an accused who is found guilty but with penalties suspended. We conclude this gives him standing to appeal." 395 F.2d at 956.

* A timely notice of appeal on behalf of Kline from the judgment of the District Court, entered October 4, 1971, was filed on November 19, 1971. The second decision of the Court of Appeals reversed the judgment rescinding the stock options awarded Mr. Kline as he had not had a hearing on that issue, and remanded to the District Court for it to exercise its discretion in determining the appropriate remedy to be entered. But the District Court decided that the "law of the case" required entry of the order issued. The issue which remains for the Court of Appeals is an extremely limited one.

tion of the power of the federal courts to award monetary relief to the Commission in an injunction proceeding (especially where no injunction is granted) was also finally determined by the Court of Appeals and is also raised in the petitions of Messrs. Holyk, Darke, Clayton and Huntington. (Docket Nos. 71-328 and 71-347). In any event, if this Court grants certiorari, the appeal before the Second Circuit will be expedited and all issues can be fully presented to this Court.

II

This Court's Supervisory Power Should Be Exercised in This Proceeding.

In this case, upon the urging of the Commission, the Court of Appeals has so far departed from the accepted and usual course of appellate proceedings as to call for an exercise of this Court's power of supervision. The respondent's brief in opposition studiously ignores Point VI (pp. 36-38) of the petition, which discusses the proper scope of appellate review.

That this is an important issue can be seen from the dissent of Judge Moore and Chief Judge Lumbard:

> "In their opinion, the majority have become so involved in usurping the function of the trial court, in selecting the witnesses they (at variance with the trial court) choose to believe, in forming their own factual conclusions from the evidence (in disregard of Rule 52a), in deciding with, of course, the benefit of the wisdom of hindsight, how they, had they been executives of Texas Gulf Sulphur Company (TGS), would have handled the publicity attendant to the exploration of the Timmins property, in determining (to their own

> satisfaction) the motives which prompted each of the individual defendants to buy TGS stock and in becoming mining engineering experts in their own right, that I find it desirable—in fact, essential—to state my opinion as to the fundamental jurisdiction of the Court of Appeals and the issues properly before us." (129a-130a)

That the majority of the Court of Appeals usurped the function of the District Court becomes apparent in respondent's recitation of "the evidence relevant to petitioners." (SEC Br., p. 7). Except for reference to certain stipulated or undisputed facts, for which respondent cites the District Court opinion, the Commission's reference to an opinion for factual matters is almost entirely to the decision of the Court of Appeals, which of course neither saw nor heard the witnesses, including the eleven experts. (See SEC Br., pp. 7-14). Circuit Judge Moore pointed out in dissent that "factually, the premise posed by the majority [as to the significance of the first drill hole] is 'clearly erroneous'" (136a), and that "the trial court's finding as to this fact is unassailable" (139a). Judge Moore also pointed out that the District Court's factual conclusions were "amply supported by the record" (140a), and that its finding that the drilling results prior to April 9, 1964 would not have had a substantial impact on the market price of TGS stock were "clearly supported by the proof upon which the court relied" (143a).*

* With respect to petitioner Kline, the Court of Appeals in its first opinion reversed the District Court's finding that Kline did not possess any information which could be deemed material. In its second opinion the Court of Appeals stated that the question of Kline's knowledge was "an extremely close one factually" (231a). Is it within the fundamental jurisdiction of the Court of Appeals to decide an "extremely close" factual question and reach a decision contrary to that reached by the trial court?

How the Second Circuit fell into error can be partially understood by further reference to respondent's brief herein. On the basis of the extensive expert testimony and other evidence produced at a four-week trial, Judge Bonsal had found that the results of the first drill core "were too 'remote' when considered in light of the size of TGS, the scope of its activities and the number of its outstanding shares [10,000,000], to have had any significant impact on the market, *i.e.*, to be deemed material" (30a). But the Commission cited to the Court of Appeals (see 141a), as it has cited to this Court, not the expert testimony credited by Judge Bonsal, but a description of the initial drill hole subsequently written by a newspaper reporter (SEC Br., p. 8). This was not the District Court's finding. The description that the drill hole was "just beyond your wildest imagination" was found by the Commission buried in a deposition of a Canadian penny stock speculator. That testimony of lay opinion was not credited by the trial court, but at the respondent's urging was adopted by the Court of Appeals.

Another example may be found at page 11 of the SEC brief, purporting to quote from Judge Bonsal's opinion following trial. It suggests that the District Court found the April 12 release to be "gloomy". That the word "gloomy" is taken out of context and was not a finding made by the District Court was pointed out by Judge Moore in dissent below:

> "Nor did he [the District Court] find the release to be 'gloomy.' His statement was that: 'While, in retrospect, the press release may appear gloomy or incomplete, this does not make it misleading or deceptive on the basis of the facts then known.' " (153a)

The SEC brief telescopes dates, events and parties together, resulting in a distortion of the facts as they developed from day to day. The resulting obfuscation of the proceedings below illustrates the danger of considering the merits from papers on an application for certiorari.

III

The Press Release Issues

Respondent quotes as a holding by the Court of Appeals below that the Securities and Exchange Commission was "charged by Congress with the responsibility of policing all misleading corporate statements" (SEC Br., p. 19). Indeed that court did use that language, but the balance of the sentence quoted from the majority opinion refers to specific statutory regulations running from the initial prospectus on a stock issue to proxy statements for corporate merger or dissolution (111a). No statutory authority was cited or can be found for "policing" good faith responses to false rumors in the public press, and no administrative rule has ever attempted to assert such authority.

In advocating the correctness of the result reached below, respondent is compelled to accept the basic premise of the petition—that Section 10(b) and Rule 10b-5 have been construed by the courts so as to in effect swallow up the particular provisions of the 1933 and 1934 Acts (SEC Br., p. 29). Respondent, however, sees this nullification of the Congressional scheme by means of judicial construction of its administrative rule as a favorable development, and makes light of the consequences.

Respondent's assertion that "Section 10(b) was intended to be as broad as the Act itself" (SEC Br., p. 29) of course begs the question. The authorities cited to support this contention in fact contradict it. Thus, *Herpich* v. *Wallace,* 430 F.2d 792 (5th Cir. 1970), holds that Section 10(b) was designed as a protection against fraud* (*id.* at 801-02), and that it reaches only "manipulative or deceptive devices or contrivances" (*id.* at 806). The Act itself reaches much farther, as respondent admits elsewhere (SEC Br., p. 40, n. 48 (con.)), to outlaw, for example, short-swing transactions by "insiders" in the absence of fraud.

Despite the sweeping assertions contained in respondent's brief (p. 30), there is no authority, other than that of the court below, to support the conclusion that the "in connection with" requirement of Section 10(b) and Rule 10b-5 can be satisfied by issuance of a press release unless its purpose is to affect the market price of the company's stock to the advantage of the company or its insiders (157a).** The recent authorities cited by respondent—

* We do not suggest that *all* of the elements of an ordinary damage suit for fraud need be proved in an enforcement proceeding, but that "all" need not be proved does not mean that "none" of the elements need be proved, as respondent implies (SEC Br., pp. 27-28). Yet the authorities cited by respondent contain phrases referring to elements of fraud which the respondent asserts it need not prove, and respondent then applies the phrases and cites cases of conceded fraud as though this record contained proof of these elements, *e.g.*, " 'securities legislation' enacted for the purpose of avoiding frauds" (SEC Br., p. 28); " 'illegitimate and fraudulent means' " (SEC Br., p. 29).

** At page 30 of its brief, respondent states that the April 12 press release "was issued to counteract the market effect of newspaper reports." Yet the Commission cites no finding by either the District Court or the Court of Appeals that this was the purpose of the release. The purpose was to warn the public of false and exaggerated rumors and to promise a factual statement as soon as responsible conclusions could be drawn from the drilling program.

Superintendent of Insurance of New York v. *Bankers Life and Casualty*, Docket No. 70-60, November 1, 1971; *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Kahan* v. *Rosenstiel*, 424 F.2d 161 (3rd Cir. 1970), *cert. denied sub nom., Glen Alden Corp.* v. *Kahan*, 398 U.S. 950 (1970)—all deal with the question of whether plaintiff was a purchaser or seller of securities defrauded in a transaction, thus having standing to sue. In this case the question is whether the "in connection with" requirement is satisfied when the *defendant* was not involved in purchases or sales of stock, nor seeking a market advantage. In their dissent below, Judges Moore and Lumbard reviewed at length the authorities with respect to this issue (155a-169a, esp. 166a-169a), and in particular discussed several cases now cited by respondent (SEC Br., p. 30, n. 29). We respectfully refer this Court to that analysis, which concludes that the majority's holding "is contrary to the intent of Congress in passing §10(b) and settled judicial construction" (157a).

As for the Commission's proposition that the legislative history supports its contention that it is the policeman of all public statements, we again refer the Court to the dissenting opinion of Judges Moore and Lumbard below (158a-169a). In particular they pointed out that the bits of legislative history relied upon by the majority to support its broad (indeed limitless) reading of Section 10(b), were in fact statements regarding the reporting and disclosure provisions of Sections 12, 13, 14 and 16 and were not directed to the provisions of Section 10(b) (162a-63a). As demonstrated in the petition herein (pp. 23-24) and supported by consistent judicial interpretation, including the

cases cited by respondent (SEC Br., p. 29, n. 34), Section 10(b) was designed to deal with problems not involved in the case at bar—that is, new devices and contrivances developed from time to time by stock manipulators. There is nothing in the legislative history to suggest that Section 10(b) was "intended to be a mandate to the Commission to erect a comprehensive regulatory system policing all corporate publicity" (158a) (compare SEC Br., p. 31) "without any of the detailed standards necessary to implement such a program" (165a).

Certainly there is no support for the respondent's contention that Congress intended by §10(b) to eliminate rights under the First Amendment. While the Commission recognizes that First Amendment rights for newspapers or pamphleteers "may be necessary," it has no tolerance for such rights for corporate officials (SEC Br., p. 45). It justifies this position on the ground that the First Amendment does not deter use of governmental power to prohibit false statements for fraudulent purposes. But here no fraud was involved, nor was speech used for any commercial motivation.

Respondent relies on numerous cases involving commercial advertising (*e.g., Donaldson* v. *Read Magazine, Inc.*, 333 U.S. 178 (1948); *Banzhaf* v. *FCC*, 405 F.2d 1082 (D.C. Cir. 1968), *cert. denied sub nom., Tobacco Institute* v. *FCC*, 396 U.S. 842 (1969), or attempts to raise money through speech (*e.g., United States* v. *Amick*, 439 F.2d 351 (7th Cir. 1971), *cert. denied*, No. 70-134 (Oct. 12, 1971); *SEC* v. *May*, 229 F.2d 123 (2d Cir. 1956)). For example, in the *Donaldson* case, *supra*, the issue came down

to whether defendants had the right "to raise money * * * by deception of the public" (333 U.S. at 192), and the Court held that the First Amendment did not include such a right. In contrast, it is not here charged that Texas Gulf, in issuing the April 12 press release, was advertising its securities or seeking to raise money. Texas Gulf's economic interests were not benefited in the slightest degree by the release, nor was such a result intended by those who issued it.

Again, it should be clear at this stage of the litigation that petitioner is not contending that it has a right to "unfettered corporate or commercial speech" (SEC Br., p. 46). What it does contend is that when, as here, a company has exercised "reasonable business judgment" while pursuing a "laudable" purpose in the public interest, without economic motivation, in commenting on matters of front-page moment, its efforts should be protected under the principles of the First Amendment.

Viewing this controversy as a whole, it is transparently clear that both the Commission and the Court of Appeals have judged the press release with the aid of hindsight. See the dissent of Judges Moore and Lumbard (130a, 150a). In so doing they have imposed different and stricter standards on voluntary corporate publicity than are imposed even on prospectuses and registration statements. But neither the 20/20 vision of hindsight nor the ability to divine what the Court of Appeals might announce as the applicable legal rules four years later were available to the Texas Gulf officials who were required to act promptly on the weekend of April 11-12, 1964. On the inconclusive evidence before them, they issued a wait and see statement warning

of the extravagant rumors and promising a later statement. There was no reason or motive for them to do otherwise. Hindsight evaluation of the press release cannot be justified on legal or policy grounds. As stated by the late A. A. Berle, Jr., in THE 20TH CENTURY CAPITALIST REVOLUTION 63-64 (1954):

> "If every decision by management were reviewable on all of its merits, the reviewing authority—court, investigation commission, regulatory authority, or whatnot—would be, in the old phrase 'substituting its business judgment for the business judgment of management.' In effect it would be running the business. If anything is settled it is that the exercise of power within the range of its permissible use is lonely business. Within that range the true judge is the conscience of the man or men who act."

IV

The Conflicting and Erroneous Materiality Tests Applied Below

In determining what facts constitute "material" information, "the Texas Gulf Sulphur decision of the Second Circuit has contributed confusion rather than clarity." Bromberg, *Financial Analysts Journal* 30 (March-April, 1969). The confusion continues. See 4 *Review of Securities Regulation* 846 (Nov. 8, 1971) which notes "the uncertainties still inherent in the materiality test * * *." Respondent's brief herein compounds the problem.

In a footnote on page 36 of respondent's brief appears one of the most remarkable statements to come out of this case—a statement by the Securities and Exchange Commis-

sion that the definition of "materiality" which it has promulgated under *all* the securities laws it administers* does not apply to Section 10(b) and Rule 10b-5! (SEC Br., p. 36, n. 40). Yet since 1934 the Commission's definition of a material fact has been as provided in Rule 12b-2(j) under the 1934 Act:

> "The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)).

There is nothing in this provision which limits its applicability to other sections of the Act; it is therefore in no way analogous to the situation in *SEC* v. *National Securities, Inc.*, 393 U.S. 453 (1969) (SEC Br., p. 36, n. 40), where the rule involved was specifically stated to be applicable to only one section of the securities laws.

If the standard of materiality under Rule 10b-5 is indeed lower than that of the remainder of the securities laws, remarkable results follow: thus, a registration statement, drafted in full compliance with the 1933 Act and the standards of materiality thereunder, could be the subject of a suit under Rule 10b-5 for failure to disclose a fact which may

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* See, *e.g.*, Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) under the Securities Exchange Act of 1934; Rule 210.1002(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405 (1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

be material under whatever unpublished definition the Commission may choose for that occasion. In such a situation, the specific disclosure requirements of the 1933 Act would serve only to entrap those who comply with their terms.

While it is true, as respondent asserts, that the Court of Appeals *stated* two common tests of materiality previously enunciated by the courts, it also stated several other tests. These tests range from a description of material facts as those which are "essentially extraordinary", and reasonably certain to have a "substantial effect" on the market, to "those facts which *may* affect the desire of investors [defined to include 'the speculators and chartists of Wall and Bay Streets'] to buy, sell or hold." (Emphasis supplied). It is this last test which was apparently *applied* by the Court of Appeals—no other test could possibly support the Second Circuit's decision on the facts as found by the trial court. As one commentator has stated regarding the Second Circuit's conflicting tests: "the two sets of ideas are inconsistent, and we will be plagued by doubts as a result. The net effect of the court's opinion is * * * to set a very low threshold of materiality", one which he finds "dangerously low from the viewpoint of persons who honestly want to know if they have information which imposes legal restrictions on them." Bromberg, *Financial Analysts Journal* 30 (March-April, 1969).

It is not true, as respondent asserts, that the District Court considered materiality from the point of view of the long-term, conservative investor, or that the effect of its decision would be to leave the speculator unprotected. What the District Court said, in accordance with the

"average, prudent investor" test, was that "information is not material merely because it would be of interest to the speculator on Bay Street or Wall Street" (25a). Judge Bonsal held that "The results of K-55-1 were too 'remote' when considered in light of the size of TGS, the scope of its activities, and the number of its outstanding shares, to have had any significant impact on the market, *i.e.*, to be deemed material" (30a). Both long-term, conservative investors and speculators are entitled to the same protection under the Act; but it does not follow that therefore different standards of materiality are applicable to various categories of investors and traders.*

V

Petitioners Did Not Have the Required Fair Warning.

If, as the Commission contends, Congress enacted the Securities Exchange Act for the express purpose of prohibiting the conduct of petitioners herein, it is certainly odd that more than thirty years passed since that enactment and more than twenty years passed since it adopted Rule 10b-5, before the Commission took the position which it has pursued in this suit. During all that period, the Commission did not promulgate a regulation specifically prohibiting the conduct here complained of. The commence-

* The authorities cited by respondent at page 35 simply miss the mark. The information to be disclosed under the securities laws is that concerning which the average, prudent investor ought to be informed; once disclosed, it can of course form the basis for a speculative judgment. What must be avoided, however, is framing rules of disclosure which require corporations and their managements to guess, at their peril, what "may" conceivably be "of interest" to a speculator. The special registration forms for "securities of a speculative nature" referred to by respondent do not contain any lesser standard of materiality than that generally applicable under the securities laws.

ment of this suit generated extreme consternation and surprise, which has not yet quieted. (See Addendum to the Petition for Certiorari, listing law review and business articles which continue to discuss this case in heated terms.)

The Commission cites *Jordan* v. *DeGeorge*, 341 U.S. 223, 231-32 (1951), for the proposition that ample notice was supplied. The case does point out that "difficulty in determining whether certain *marginal* cases are within the meaning of the language under attack as vague does not automatically render a statute unconstitutional for indefiniteness." *Id.* at 231. (Emphasis added). We do not understand the respondent to be asserting that petitioners' conduct was marginal. We heartily concur with the test there enunciated by this Court:

> "The test is whether the language conveys sufficiently definite warning as to the prescribed conduct when measured by common understanding and practices." *Id.* at 231-32.

As Judge Moore pointed out in suggesting that resolution of the many problems presented here should be through rule-making procedures:

> "The companies, the securities of which are listed on exchanges, their employees and investing public alike should have some knowledge of the rules which will govern their actions. They should not be forced, despite an exercise of the best judgment, to act at their peril or refrain *in terrorem* from acting." (145a)

Respondent at pages 36 and 37 of its brief and footnotes 42 through 45 contends again that its administrative decisions, press releases, briefs *amicus curiae* and other

publications amply warned petitioners that their conduct was covered by Rule 10b-5. However, the Administrative Procedure Act contains specific provisions for promulgation and dissemination of substantive rules as authorized by law and statements of general policy or interpretations, and as amended in 1966 (80 Stat. 250), Section 1002(a) adds that no person may be "adversely affected by" informally published matter such as cited by the respondent.

The Administrative Procedure Act, amended in 1966, requires that all administrative opinions issued after July 4, 1966 be indexed "providing identifying information for the public," and that:

> "No final order, opinion, statement of policy, interpretation, or staff manual or instruction that affects any member of the public may be relied upon, used or cited as precedent by an agency against any private party unless it has been indexed and either made available or published as provided by this subsection or unless that private party shall have actual and timely notice of the terms thereof." 5 U.S.C. §1002(b), 80 Stat. 250.

The authorities cited by respondent to show that fair warning was given did not comply with these requirements of law. Of the four Commission opinions cited by respondent in footnote 42, one was not even indexed and the other three are indexed under Section 15 of the Exchange Act, not §10(b) or Rule 10b-5. That those decisions may have come to the attention of broker-dealers whose conduct is regulated by §15, and who continually are apprised of SEC activity, can not justify the contention that these petitioners, unconnected with the securities industry, had their "attention called" to the respondent's

position taken in this case. It is significant that all of the authorities cited by the respondent to support its statement that "the results reached by the court of appeals follow logically from the development of the federal securities laws in this area" actually follow the filing of the complaint in this action wherein the new law was sought to be made (SEC Br., p. 25, n. 19). The impact which the Commission's complaint and the decisions of the Courts below have had as reported in the press is eloquent testimony that fair warning had not been received by the public at large, including even the sophisticated investment community.

Conclusion

We again urge that the petitions filed in this case be considered along with the petition filed in the Tenth Circuit litigation against Texas Gulf Sulphur by Mitchell and Reynolds (No. 71-421). These two cases raise issues of great importance to the business and investment communities and to the public generally which have never been decided by this Court.

The petition should be granted.

Respectfully submitted,

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November 24, 1971

Supreme Court, U.S.
FILED
JAN 14 1972
E. ROBERT SEAVER, CLERK

IN THE

Supreme Court of the United States

October Term, 1971

No. ~~327~~ 71-327

TEXAS GULF SULPHUR COMPANY, a Texas corporation, CHARLES F. FOGARTY, RICHARD D. MOLLISON, CLAUDE O. STEPHENS and HAROLD B. KLINE,

Petitioners,

v.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

PETITION FOR REHEARING

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TABLE OF CONTENTS

	PAGE
I—This petition may be considered by the full Court of nine Justices	2
II—The entire thrust of SEC administration of the securities laws has been to discourage premature predictions and to encourage conservative evaluation of mining exploration results; it contravenes basic fairness to apply *ex post facto* contrary principles in this case	3
III—Shifting the burden of proof from the SEC to Texas Gulf after trial was unwarranted and unfair	7
IV—Creation and application of a new and unique standard of materiality under Section 10(b) was unfair to petitioners and is totally unworkable in the context of the securities laws	8
Conclusion	11
Certificate of Counsel	11

TABLE OF AUTHORITIES

PAGE

Cases:

National Lithium Corp., 40 S.E.C. 746 (1961) 5

Pan-American Gold Ltd., 31 S.E.C. 141 (1950) 5

Reliance Electric Company v. Emerson Electric Company, 40 U.S.L.W. 4125 (U.S. Jan. 11, 1972) 10

Statutes:

Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq.*
Section 10(b), 15 U.S.C. §78j(b) 9

SEC Rules and Regulations:
Regulation A, Item 8A 4
Regulation C, Rule 405 (17 C.F.R. §230.405(1)) 9n
Regulation S-X, Rule 210.1002(g) (17 C.F.R. §210.1-02(g)) 9n
Rule 8b-2 (17 C.F.R. §270.8b-2) 9n
Rule 10b-5 (17 C.F.R. §240.10b-5) 9
Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)) 9

Miscellaneous:

New York Stock Exchange Company Manual 6

Painter, *Rule 10b-5: The Recodification Thicket,* 45 St. John's L. Rev. 699 (1971) 10

Report of the Special Study of the Securities Market of the Securities and Exchange Commission, H. R. Doc. No. 95, Pt. 3, 88th Cong., 1st Sess., 1963 5

Stern & Gressman, Supreme Court Practice (4th ed. 1969) 2n

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PETITION FOR REHEARING

Petitioners respectfully move this Court for an order (1) vacating its denial of their petition for writ of certiorari, entered on December 20, 1971, and (2) granting the petition. In support of this motion, petitioners state the following:

I

This petition may be considered by the full Court of nine Justices.

The petition for certiorari was denied on December 20, 1971, with Justices Stewart and Blackmun dissenting. Since that time, two new Justices have become members of this Court, and this landmark case may now be considered by the full Court*.

There can be no question as to the great public importance of the issues presented in this action. The significance of the case is evidenced by the plethora of books, law review articles and other commentaries regarding it, some of which are listed in Appendix A to the petition. On a previous occasion, Mr. Justice White dissented from the denial of certiorari with respect to one part of this case stating that the issues "are of general importance" (394 U.S. 976), and as previously noted, Justices Stewart and Blackmun dissented from the most recent denial. In addition, the petition for rehearing and petition for certiorari in *Texas Gulf Sulphur Co.* v. *Mitchell* (Docket No. 421) raise questions of private damage liability which are of great moment to publicly held corporations. We respect-

* While Rule 58(1) of this Court provides that a petition for rehearing of judgments or decisions other than those denying or granting certiorari "will not be granted, except at the instance of a justice who concurred in the judgment or decision and with the concurrence of a majority of the Court," no such restriction appears in subdivision (2) of Rule 58, relating to petitions for rehearing of denial of certiorari. Similarly, the practice for new Justices not to participate in the consideration of a petition for rehearing after decision on the merits would not seem to apply to consideration of a petition for rehearing of denial of certiorari. *Cf.* STERN & GRESSMAN, SUPREME COURT PRACTICE §§15.6 and 15.7 (4th ed. 1969).

fully request the entire Court to consider the points set forth in the petition for certiorari here and in *Mitchell* and to grant the petitions so that the issues involved in these landmark cases can be reviewed by this Court.

II

The entire thrust of SEC administration of the securities laws has been to discourage premature predictions and to encourage conservative evaluation of mining exploration results; it contravenes basic fairness to apply *ex post facto* contrary principles in this case.

The extent to which the SEC has heretofore encouraged a conservative approach in statements regarding mineral exploration was not sufficiently brought to the attention of this Court in the petition for certiorari. (See p. 26, note). This careful approach has appeared in, and has indeed pervaded, regulations promulgated by the SEC almost from the inception of its administration of the securities laws; in administrative decisions under these laws; in interpretative press releases; and in *amicus* briefs filed by the SEC in other cases. Such a careful approach is in accord with all treatises and teaching in the fields of geology and mining.

The geologists and mining engineers who comprised the management of Texas Gulf and who prepared the April 12 press release had been, over the years, conditioned, as had the whole business community (perhaps to a lesser extent) by the enforced conservative approach of the SEC to exploration results. Nevertheless, Texas Gulf mining

experts have been *ex post facto* condemned by the Second Circuit and, on remand, by the District Court, for not being publicly exuberant about the results from just three completed 1⅛ inch drill holes, only one of which had been chemically assayed. The essential unfairness of this approach is another ground for grant of the petition for certiorari.

The basic provision adopted by the SEC with respect to disclosure of mining exploration results is contained in Schedule I to Form 1-A relating to Regulation A Offerings under the Securities Act of 1933:

> "[n]o claim shall be made as to the existence of a body of ore unless it has been sufficiently tested to be properly classified as 'proven' or 'probable' ore, as defined below. If the work done has not established the existence of proven or probable ore, a statement shall be made that no body of commercial ore is known to exist on the property." Item 8A(b)

"Proven" and "probable" ore have always been defined by the SEC as follows:

> "(c) The term 'proven ore' means a body of ore so extensively sampled that the risk of failure in continuity of the ore in such body is reduced to a minimum. The term 'probable ore' means ore as to which the risk of failure in continuity is greater than for proven ore, but as to which there is sufficient warrant for assuming continuity of the ore." Item 8A(c)

The SEC regularly applies these provisions to registration statements under the 1933 Act as well as to proxy materials under the 1934 Act. Extensive supporting data is required before the Commission will permit statements indicating that exploratory results are of commercial significance.

Numerous administrative decisions of the SEC have confirmed this conservative approach. Thus in *Pan-American Gold Ltd.*, 31 S.E.C. 141, 147-48 (1950), the Commission stated that:

> "* * * three diamond drill holes are insufficient to determine whether a commercial ore body is present, even though they should encounter a gold-bearing structure."

In *National Lithium Corp.*, 40 S.E.C. 746 (1961), the Commission held that estimates of ore reserves included in a geologist's report as an exhibit to a Registration Statement were materially misleading because the geologist had not sufficiently investigated the economic factors which would determine the profitability of the proposed operation, such as availability of markets and mining, milling and transportation costs. In addition, the Commission concluded that:

> "* * * the record establishes that the 26 drill holes [in certain areas] were insufficient to support * * * reserve estimates [for those areas] * * *." *Id.* at 755

The SEC's administrative emphasis on caution is not confined to the mining areas. Thus in the *Report of the Special Study of the Securities Market of the Securities and Exchange Commission*, H. R. Doc. No. 95, Pt. 3, 88th Cong., 1st Sess., 1963, the Commission stated:

> "Overenthusiastic or premature publicity concerning product developments constitutes another potential abuse." *Id.* at 91.

The SEC report went on to describe as illustrative of possible abuse, a corporate announcement of a scientific development made in May, 1960 and noted that "by the Spring of 1962, the plant was not yet in operation. * * *" *Id.* at 92.

The New York Stock Exchange in its *Company Manual* also provided in 1964 that "premature announcements of new products whose commercial applications cannot yet be determined realistically, overly optimistic forecasts, exaggerated claims, and unwarranted promises should be avoided." *Id.* at A-20.

It was against this background of nearly thirty years of enforcement of the securities laws that the April 12, 1964, press release was drafted.

With only three 1⅛ inch drill holes completed, Texas Gulf in April, 1964, was clearly acting responsibly* in shunning premature claims when further drilling might well have shown that the strike had little or no commercial significance to a company with 10,000,000 outstanding shares, with annual sales in 1963 of more than $62,000,000 and earnings of more than $9,000,000, and with working capital of almost $47,000,000. Accordingly, the Texas Gulf mining engineers who prepared the release issued on Sunday, April 12, 1964, stated, in response to published rumors, both exaggerated and false, that no definite conclusions could be made until further drilling was completed. The release promised a clarifying public statement as soon as responsible conclusions could be drawn.

Texas Gulf's press release of April 12, 1964, as initially determined by the District Judge who heard and saw the witnesses, was issued in the exercise of reasonable business judgment and fully conformed with the standards theretofore insisted upon by the SEC and the New York Stock Exchange.

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* Six of the nation's leading independent experts so testified and Judge Bonsal so found after a four-week trial.

III

Shifting the burden of proof from the SEC to Texas Gulf after trial was unwarranted and unfair.

On the original trial Judge Bonsal found on the evidence that the SEC had failed to establish that the April 12 release was false or misleading. On remand, however, and over Texas Gulf's objection, the District Judge felt constrained by the majority opinion of the Court of Appeals to receive the testimony of former Texas Gulf stockholders who said that they had been discouraged by the release and had therefore sold their shares. Other stockholders, who the Court found were equally reasonable investors, testified that they were encouraged by the release either to buy or hold Texas Gulf shares. Although the burden of proof should have rested on the SEC as plaintiff, the courts below have concluded that since *some* persons claimed to have sold their shares because of the release, the release was therefore misleading.* Thus was the burden of proof shifted from plaintiff to defendant and, in order to prevail, Texas Gulf, was in effect required to show that no selling stockholder had been influenced by the release.

The courts below also shifted the burden of proof on another important aspect. Rather than requiring the SEC to prove fraud or even negligence on the part of Texas

* The District Court on remand held that the press release was misleading on the basis of the following finding:

> "All of the shareholders appear to have been reasonable investors as that term has been defined by the Court of Appeals, and all were influenced by the press release, some selling their shares, and others holding their shares or purchasing shares." 312 F. Supp. at 83.

Gulf, the company was required to prove its own "due diligence", *i.e.*. to prove that it was not negligent. Despite having satisfied the trial court, which initially found that Texas Gulf had exercised reasonable business judgment in drafting and issuing the release, the company was nevertheless required to prove something more to obtain exoneration.

The implications of the procedure followed by the courts below are alarming indeed. The same news item may persuade some investors or speculators to sell shares while others will buy. If subsequent events suggest that a class of investors took the wrong course, the disappointed class might well be able to claim against the issuer of the news item and its stockholders. What the defendant must prove to avoid such liability remains shrouded in confusion.

IV

Creation and application of a new and unique standard of materiality under Section 10(b) was unfair to petitioners and is totally unworkable in the context of the securities laws.

In a footnote on page 36 of its brief in opposition to the petition appeared a remarkable concession by the SEC, a concession which was necessary in order to justify the decision below but which was nevertheless contrary to the SEC's administration of the securities laws for the past 37 years. Perhaps because of its appearance in a brief in opposition and in a footnote, this concession did not receive the notice and attention which it deserves. The footnote in effect contends that the definition of "materiality"

which the SEC has promulgated under all the securities laws it administers does not apply to Section 10(b) and Rule 10b-5! Yet since 1934 the Commission's definition of a "material" fact has consistently been as provided in Rule 12b-2(j) under the 1934 Act:

> "The term 'material' when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." Rule 12b-2(j) (17 C.F.R. §240.12b-2(j)).*

If, as the Commission now argues, the standard of materiality under Rule 10b-5 is indeed lower than that applicable to the remainder of the securities laws, then the Commission's regulations and the specific disclosure requirements of the securities laws would serve only to entrap those who comply with their terms.

The definition of materiality which the Second Circuit found necessary to adopt at the urging of the SEC in order to justify the result below, contrary to the SEC's definition of 37 years standing, has been widely, and currently, criticized. Thus, most recently, Professor William Painter, a leading authority on the securities laws, writing in November, 1971, states that if the Second Circuit's test is to be taken literally, it

> "* * * becomes so broad as to be nearly unworkable. Rumors and guesses, educated or otherwise, motivate

* See also the identical substantive test in Rule 210.1002(g) (17 C.F.R. §210.1-02(g)) of Regulation S-X which governs all financial statements filed under the securities laws; Rule 405 (17 C.F.R. §230.405(1)) of Regulation C under the 1933 Securities Act; and Rule 8b-2 (17 C.F.R. §270.8b-2) under the Investment Company Act of 1940 (15 U.S.C. §80a-1).

> the speculator, as well as what could only be described as the mood of the moment and crowd psychology. To impose an affirmative duty to disclose all that might be relevant to speculators, chartists and others would seem to condone if not encourage the type of premature release of unreliable or unripe facts which it would be wiser to withhold. * * *'' Painter, *Rule 10b-5: The Recodification Thicket,* 45 ST. JOHN'S L. REV. 699, 710-11 (1971).

He further points out that the Second Circuit test

> "* * * seems highly conceptual if not impossible for the average insider to use as any sort of a practical guideline. In the final analysis, it may come down to little more than saying that materiality depends upon the facts of each case, retroactively determined by the particular court in which you happen to be sued, acting with the benefit of hindsight." *Id.* at 711.

The fact is that the Second Circuit fell into obvious error in announcing that a fact is material under Rule 10b-5 if it "may" be of interest to a speculator or "might" affect the market price of a security, even though that same fact would not be material, under existing SEC regulations, for inclusion in a proxy or registration statement.* Such are the rules by which lawyers are now expected to advise their clients. Surely the public is entitled to better guidance than tests as elusive and contradictory as these. The case at bar presents appropriate facts for this Court to deal with these important questions.

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* Just this week this Court has in effect instructed the SEC to proceed by administrative or legislative means, not by judicial proceedings, if it seeks to change the long-standing prohibitions of the 1934 Act. *Reliance Electric Company* v. *Emerson Electric Company,* 40 U.S.L.W. 4125 (U.S. Jan. 11, 1972).

Conclusion

For these reasons, as well as those contained in the petition for a writ of certiorari herein and in *Texas Gulf Sulphur Co.* v. *Mitchell* (No. 421) petitioners pray that this Court grant rehearing of both petitions and order a review of the judgments and opinions below.

Dated: January 14, 1972

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As counsel for the petitioners, I hereby certify that the petition for rehearing is presented in good faith and not for delay, and as described above, is restricted to the grounds specified in Rule 58(2).

/s/ ORISON S. MARDEN

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